EconoFact Chats: China's Economic Rise, and Its Current Economic Challenges

Eswar Prasad, Cornell University

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Michael Klein:

I'm Michael Klein, executive editor of EconoFact, a non-partisan web-based publication of The Fletcher School at Tufts University. At EconoFact, we bring key facts and incisive analysis to the national debate on economic and social policies, publishing work from leading economists across the country. You can learn more about us and see our work at www.econofact.org.

Michael Klein:

The economic rise of China is perhaps the most consequential economic event of the past half century, or even over a much longer timeframe. Hundreds of millions of people benefited from the economic growth of the country, with many of them emerging from dire poverty. There were of course, large effects of rising China throughout the world as well. China has contributed about one quarter of the growth of the world's GDP over the past two decades. It is the biggest trading partner for more than 60 countries. Its exports to the United States rose by more than 100 fold over the past 40 years, and its GDP rose in 79 of the last 80 quarters.

Michael Klein:

But now China like many other countries is facing deep challenges. To understand how China emerged, the sources of its growth and its current challenges, I'm very pleased to welcome back to EconoFact Chats, Professor Eswar Prasad of Cornell University. Eswar is particularly well-positioned to discuss these topics. Before his appointment at Cornell, Eswar worked at the IMF, where he was the head of its China division. He has testified in front of Congress on the Chinese economy and also has written many articles and books on it. Eswar, welcome back to EconoFact Chats.

Eswar Prasad:

Michael, it's such a pleasure to be back on your podcast. Thank you so much for the repeat visit.

Michael Klein:

Well, it's great to have you back. Last time we talked about cryptocurrencies and I guess you were quite prophetic in that. Let's see how prophetic you can be about China as well. But before we go to prophecies, let's go to history. Eswar, how did China start to open, and when, and under whom?

Eswar Prasad:

So China over the last three decades has taken some steps towards becoming a market-oriented economy. Deng Xiaoping was an important reformist who seemed to recognize that in order to improve the living standards of the Chinese population, he needed to open up the economy to the world and more importantly to use the opening up process in a way that would create domestic reforms that would get the economy to be more dynamic and better meet the needs of its citizens. So for the last three to three and a half decades, China has been on this path towards becoming a more dynamic, and somewhat more market-oriented economy although that process in particular has seen its limits.

Michael Klein:

So as you're indicating, a lot of this was export-led growth and it involved the integration of China into the world economy. Many people point to the ascension of China to the World Trade Organization. How important do you think that was?

Eswar Prasad:

It was very important in terms of catalyzing some domestic reforms, because what many Chinese reformers wanted to have the Chinese economy do was to be able to stand up on its own feet and for Chinese corporations to be able to compete with the rest of the world. Now there were a lot of people in China including many in the government and in the Politburo who were somewhat opposed to this opening up. So there was a sort of pact made that entry into the World Trade Organization and the potential price of gaining easier access to markets around the world would be used to undertake certain domestic reforms.

Eswar Prasad:

Now what happened is that in the early years of China's accession to the WTO, that is in the early 2000s, China did benefit a great deal in terms of being able to gain access to markets in the rest of the world, but this does not hugely contribute in a direct way to China's GDP growth, because a lot of this trade was actually processing trade. In other words China would import a lot of intermediate goods, and other imports from other countries and then add a little bit of value to those products in terms of packaging and putting them together and then ship them off to the rest of the world.

Eswar Prasad:

So while China seemed to be an export machine, in terms of the bottom line, in terms of value added, it was less important in terms of growth than domestic investment. What is less well realized about China's growth is that during the 2000s and even the 2010s, it was domestic investment that played a really huge role in boosting China's growth. And this was of course backed up by huge savings pool in China. So that's the real story of Chinese growth, but the exports played a very important role in getting some economic dynamism into the economy, which certainly played a very important role.

Michael Klein:

So in terms of the GDP growth, a big question was whether or not that could be sustained. And there was a famous article that Paul Krugman wrote in Foreign Affairs where he talked about the fact that a lot of the growth wasn't necessarily because the economy was becoming more productive, instead it was sort of a reallocation within the economy of people moving from the inland area to the coast which was a much more dynamic place. And that would suggest that there were real limits to the potential for growth. What was your view and what is your view Eswar of that argument?

Eswar Prasad:

If you look at growth in the 2000s and into the previous decade as well, Michael, there are three important components to it. One, was the huge amount of investment. When you as a country save a lot and then invest a lot, that certainly shows up in terms of more GDP growth. Now whether that is [inaudible] GDP growth is an important question. And the answer is probably not entirely because a lot of this investment was financed by the state-owned banking system and largely went to finance capital accumulation by state-owned enterprises.

Eswar Prasad:

The second element is related to reallocation of labor from the less productive parts of the economy, especially agriculture and other primary industries to the more productive parts of the economy, especially manufacturing. So that part of the growth process may have run its course to some extent, but no matter which way you slice the data, it turns out that China did generate a decent bit of productivity growth. What economists such as you and I know Michael as total factor productivity growth is something that China did manage to generate. Now this turns out to be the case no matter how you slice the data.

Eswar Prasad:

Susan Collins, who's now the president of the Boston Fed and one of my other Brookings colleagues, Barry Bosworth have some very interesting analysis showing that during the 2000s, it was investment accumulation or capital accumulation through investment, but in addition, productivity growth in every sector of the economy, but particularly so in manufacturing, that boosted growth. Now this is a little odd because this is an economy where inefficiencies are rampant, where the allocation of resources is not very efficient, but somehow China did manage to generate a decent bit of productivity growth, but unfortunately that productivity growth has been slacking off quite significantly in the last few years. So whether that can be sustained, it's an important question for China, and the world economy.

Michael Klein:

Well, let's move to what's going on currently. As you mentioned, Eswar, there has been a slowdown in growth and Xi Jinping has this new development concept where he's interested in both self-reliance, but also I guess recognizes that this integration into the world economy for the reasons you were suggesting were very important. What do you see as the challenges facing China right now, even absent COVID, I'd like to ask you a little bit more about COVID in a minute, but even absent that, the slow down predated COVID. So what do you see as happening more recently?

Eswar Prasad:

The Chinese government has been very good at laying out broad frameworks within which to think about its economic policies. Xi Jinping a few years ago articulated this concept of dual circulation. And dual circulation essentially means greater self-reliance on domestic technology, on domestic innovation, less reliance on the world in order to grow, but at the same time maintaining integration with the rest of the world economy, because I think even someone like President Xi Jinping who does not seem to be a market oriented reformer at heart, seems to recognize that the economy does benefit from integration into the world economy. But I think there are concerns that too much reliance on the rest of the world for export markets, for technology or financial services does leave the economy vulnerable. So the dual circulation strategy does seem to be an approach to try to reduce that vulnerability at least. Now what is interesting about China's approach to reforms and economic policies in general is really that it has resulted in a bundle of contradictions that are going to be hard to resolve.

Eswar Prasad:

So for instance, how do you manage to get the private sector in China to do all this innovation and increase productivity while at the same time the government seems very keen on promoting the state sector and also on tamping down the power of the private sector? Likewise, how do you move towards generating more market oriented discipline, especially in the financial markets while at the same time the government is playing a very big role in terms of the financial system, and in terms of providing implicit guarantees in many parts of the financial system? These sorts of contradictions I think are going to be a little difficult to resolve and they lead to a lot of stumbles and missteps. Although I don't think they're necessarily going to create either economic or financial collapse as some people seem to be betting.

Michael Klein:

So let's think about the state sector for a while. What you mentioned earlier was a lot of investment went through state owned banks to state owned companies effectively. And are the state owned companies in China seen as a drag on the economy? Are they ways in which the government is effectively just transferring wealth to either workers to keep them quiescent, or to the managers in some form of corruption? Or does the state owned sector provide important services and goods and is it some kind of dynamism in the economy?

Eswar Prasad:

So the state owned enterprise sector, the SOE sector was in a sense seen as the social safety net in China because it not only provided employment, but a variety of social services, including pensions, health benefits, and a variety of other benefits, including housing. Now over time the Chinese government has tried to harden the budget constraints on state owned enterprises, but many state owned enterprises are still quite profitable, so you might think that they're in fact quite dynamic, but the reality is that state owned enterprises have benefited from the policies of the government. Many of them have monopolies in the sectors that they operate in. They get cheap financing from the state owned banks. Many of them get cheap land, very cheap energy. So all of this has led to many SOEs having very capital intensive, that is physical capital intensive models of growth which connects back to my earlier statement about China having experienced investment led growth through the state owned enterprises.

Eswar Prasad:

So this has not been very good at generating jobs through the state owned enterprise sector. So in terms of innovation, job creation, productivity growth, the economy has largely relied on the private sector, but the state sector still plays a very important role in the economy, but its apparently good performance I think should be taken with something of a grain of salt, given all the advantages that economic policies have given the state owned enterprise sector. But the government does seem to recognize that ultimately it cannot get the sort of economic realignments and productivity gains it wants unless the state owned enterprise sector is also pulling its weight.

Michael Klein:

Well, what about the private sector then? What kinds of dynamism do we see in the private sector? And to what extent does a policy of self-reliance choke that off because of say technological needs from abroad or the role of China in a supply chain?

Eswar Prasad:

Now the private sector does play a very important role in terms of employment creation as I mentioned, but one of the major albatrosses around the neck of the private sector is that it doesn't get much financing from the formal financial system. In fact this has been a longstanding gripe of small and medium enterprises that they don't get funding from the state owned commercial banks. Now it's not that the banks are behaving irrationally. The reality that they see is that enterprises in the private sector are inherently riskier, but state owned enterprises on the other hand are implicitly backed up by the government. So even inefficient state owned enterprises are more likely to get bank credit simply because they are safer in terms of the banks knowing that they will eventually have the loans repaid by the government if not by the enterprises themselves.

Eswar Prasad:

The operating environment also is not a very favorable one for private enterprises even though the government relies on them for employment growth and productivity gains. Now there are certain parts of the economy where the private sector has a very important role, especially in the services sector where the government has tried to generate more dynamism. So right now the Chinese government does seem to be endeavoring to get the financial system to reorient its financing flows towards the private sector, but this is not working terribly well yet.

Eswar Prasad:

The other issue is that there are certain parts of the private sector, especially the tech sector, which is certainly creating some world class companies, at least in terms of size, and also to some extent in terms of innovation. But here the government seems to have a set of concerns that these companies such as the Ant Group for instance, might be growing too large and too politically powerful for the government's comfort. So those companies are being taken down in some fashion or the other. So this is putting something of a limit on private sector innovation. And I think this is, again going to be a fundamental contradiction that the Chinese government is going to have to find a way to resolve. How do you count on innovation and creating world-class companies when you don't want them to become too economically and politically powerful?

Michael Klein:

So you mentioned financing and domestic financing. Another possible source of financing of course could be from abroad. And this is also linked to the issue of whether or not the renminbi could become a world currency. And we really haven't seen much development of that. And we also don't see necessarily a lot of investment in China because I think people are rightly concerned about expropriation, or the way in which companies as you mentioned survive or thrive might not be due to market forces. What do you see in terms of the external financing availability for China? And also, I guess the question of whether or not the renminbi could be a global currency.

Eswar Prasad:

So the reality is that for a number of years China has actually been exporting its savings to the rest of the world. It's been running current account surpluses. So it's not so much a lack of financing that is a real constraint in terms of getting money to companies that could use it in a productive way. It's just that the financial system is not working terribly well. But here again, the Chinese government seems to recognize that having foreign investors play a role in capital allocation of the economy could be useful maybe because they don't have the legacy problems of Chinese state-owned banks, so they can in fact finance some of the more productive companies with good innovations, good business ideas, and so forth. So the government has always been relatively open to foreign direct investment that is direct investment by foreign investors in Chinese companies, but more recently it's become more open to foreign investors investments into its equity markets, as well as its bond markets.

Eswar Prasad:

There is a problem however. There is a real concern among foreign investors that their investments could potentially be expropriated or at a minimum that it might be difficult for them to repatriate their investments if in fact, the Chinese economy were to suffer any problems and there were to be an outflow of capital that led to a currency depreciation. In that sense, there is a fear that the government might impose capital controls, making it harder for foreign investors to take their money out. I think there are also questions about whether the institutional framework in China is something that foreign investors can put their trust in. So for instance, if you think about other major reserve currency economies, such as the United States, Japan and all of the others, they have a strong institutional framework, including an independent central bank, and institutionalized system of checks and balances, the rule of law. China does not have any of this and has shown no indication of these sorts of institutional reforms. So absent those it's hard for me to see the Chinese currency, the renminbi becoming a safe haven currency. But of course, China's sheer might in terms of its contribution to global GDP, its share of global trade means that the Chinese currency is likely to become a more important payment currency at least, although even that is going to be contingent, as I indicated in my 2016 book on the renminbi, on China's willingness to continue opening up its capital account, reducing restrictions in capital inflows and outflows and allowing its currency to float more freely.

Michael Klein:

So Eswar, I'm guessing that you don't have a big part of your portfolio in the Chinese stock market based on what you said.

Eswar Prasad:

Michael, I only invest in broadly diversified mutual funds. So if any of them hold Chinese assets, I probably hold some Chinese assets indirectly, but nothing directly.

Michael Klein:

Okay. There we have investment advice. That's great. So I have to conclude by asking about COVID and the zero-COVID policy and both what that's doing to China now and what that implies more broadly about leadership in China and the Chinese system. So can you discuss a little bit, Eswar how this zero-COVID policy has emerged, what it's done and what it reflects about the Chinese economy and the Chinese system?

Eswar Prasad:

So it certainly shows a lack of flexibility in the Chinese system because given what we know about the transmissibility of different variants and the inevitability of having to live with COVID, which I think the reality is, the reality of the world is getting used to maintaining a zero-COVID policy, especially in such a large economy with densely packed urban centers, it's going to be very difficult. But the Chinese government is not one to admit to any mistakes in terms of its policy making. So I think it's determined to push forward this policy and it's had some consequences in terms of rolling shutdowns of different parts of the economy, although one might at some level say that China has had a much better outcome in terms of the number of fatalities from COVID. So maybe if one put a price on human life, one could argue that the Chinese have come out better at some level, but it also has certainly put a substantial crimp on growth in the last few quarters.

Eswar Prasad:

The Chinese economy is already facing long term headwinds because of unfavorable demographics and a variety of other constraints and inefficiencies that are holding back growth. On top of that, the zero-COVID strategy has certainly held back growth because at the same time the government is trying to implement the strategy, it's also been trying to cool off speculation in the housing market, prevent additional leverage from building up in the system that could lead to financial market problems in the future. So it's been a set of circumstances that have really pulled down growth. The Chinese government now seems to be easing up a little bit on its COVID policies, but more importantly also infusing some macroeconomic, that is monetary and fiscal stimulus, which should get the economy once again, slowly back on its feet. But the rest of 2022, I think is going to be a pretty rough year for China. And given how important China is for the world economy, I don't think China is going to be much help and could remain at least a modest drag on the world economy for now.

Michael Klein:

As I mentioned in the introduction, the rise of the Chinese economy is one of the most consequential events of at least my lifetime, and perhaps much longer than that. And Eswar, thank you very much for helping explain some key and central aspects of that in what we're seeing today. I think you really made it clear what's going on and you've given people a good background to help understand what has happened, what is going on now, and perhaps what will happen in the next few years. So thanks very much for being on the show once again, Eswar.

Eswar Prasad:

That was a fun conversation, Michael, always a pleasure to talk to you. Thank you.

Michael Klein:

Thank you.

Michael Klein:

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