China’s Economic Reforms and Growth Prospects

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The emerging consensus among commentators on the Chinese economy is that China is in for a credit crisis and/or a period of much slower economic growth. China boosted its economic growth during the global financial crisis by a massive stimulus program, financed almost entirely by an increase in bank lending. That has led to an unprecedented increase in leverage. Including off balance sheet credit and credit extended by non-banks, the ratio of private credit to GDP has jumped by over 60 percentage points, from 125 percent at the end of 2008 to 190 percent by the end of 2013.\(^1\) Jon Anderson notes this increase is “one that is not only huge by Chinese historical standards but also places China near the top of the emerging market league tables in terms of the five-year increase in credit penetration.”

The critique of the credit driven growth of recent years has two dimensions. First, while the stimulus allowed China to achieve growth averaging well over nine percent in 2009-2011, growth has since slumped to under eight percent even as credit has continued to expand, leading to the conclusion that credit has been massively misallocated. Second, credit increases of the magnitude seen in China have frequently been a harbinger of financial crises in other economies, typically triggered by a sudden stop in credit growth or the collapse of an asset bubble. Indeed some claim that “A financial crisis in China has become inevitable.”\(^2\)

Others argue that China’s authorities must now engineer a multiple year slowdown in credit growth to reduce the risk of a financial crisis. But inevitably, it is argued, this moderation in credit growth will slow the growth of the Chinese economy, perhaps dramatically and for a prolonged period of time. One well-known analyst forecasts that China’s average growth in the decade ending in 2023 will average no more than three to four percent.\(^3\)

The central arguments of this paper are that these pessimistic arguments exaggerate the likelihood of a financial crisis and overlook the growth enhancing potential of the reforms endorsed by the Chinese Communist Party at the Third Plenum in November 2014.
There are several reasons to believe that the probability of a financial crisis in China is low. First, all of the credit is domestic in origin, meaning China is not vulnerable to a sudden stop in foreign funding, as occurred in several countries at the time of the 1997 Asian financial crisis. Second, China’s bank credit boom is largely financed by deposits rather than through the wholesale market, which is more vulnerable to sudden stops. Most importantly, on a net basis China’s systemically important banks finance very little of their lending by accessing funds through the interbank market. Third, China’s financial system has almost no securitization of loans or other assets. Securitized assets were a major source of financial instability in the United States and other advanced economies during the global financial crisis. Fourth, China has a national saving rate of around 50 percent, far and away the highest in the world, which makes financing a large credit build up more feasible. Finally, it should be noted that due to its very strong external position China is not vulnerable to the capital outflows that in a number of emerging market economies have accompanied the so called tapering in the pace of asset purchases by the US Federal Reserve. Several of these economies have been forced to raise interest rates in an attempt to reduce these outflows, but are likely to suffer slower growth as a result.

The key growth enhancing reforms endorsed at the Third Plenum are the adoption of market-oriented liberalization of deposit rates and the elimination of state monopolies except in the case of natural monopolies. China’s central bank has long set a ceiling on the rates that banks can pay on deposits. The bank’s use of this authority has resulted in a very sharp decline in real deposit rates since 2004, as reflected in figure 1. Figure 2 provides evidence that the return on deposits offered outside of normal banking channels, for example via wealth management products and money market funds, is substantially higher than bank deposit rates, suggesting that liberalization of bank deposit rates will lead to significantly higher real rates. And if banks have to pay more on their liabilities they will seek to earn more on their assets, meaning bank lending rates are likely to rise. This increase is likely to be positive for China’s economic growth.
But won’t higher lending rates reduce the rate of investment, inevitably slowing economic growth? Not necessarily. I believe that the overlooked result of higher rates is that more bank lending will flow to the private sector where, on average, return on assets is more than twice as high as in state firms. Data on return on assets in the industrial sector is shown in figure 3. Returns of private industrial firms have always been higher than state firms and the margin has widened significantly since 2006. By 2012 the returns of private firms were about two and a half times those of state firms. For the service sector data is far less complete, but based on the 2008 economic census, which provides data on ten of fourteen service subsectors, the return on assets of state firms, 3.4 percent, was half the 6.6 percent returns of non-state firms. In short, state firms in both the industrial and service sectors already earn substantially less than their cost of capital. This undoubtedly in part explains that in the three years 2010-2012 banks lent 50 percent more funds to privately controlled companies than to state firms. The margin in favor of lending to privately-controlled firms is likely to increase as bank lending rates rise.
The elimination of state monopolies is likely to magnify the growth enhancing effect of deposit rate liberalization. In manufacturing, outside of the petroleum and tobacco industries, privately-controlled firms have faced few barriers to entry and have largely displaced state and collective firms. In 1978 state and collective firms accounted for 100 percent of manufacturing output but by 2011 their share had fallen to only 21 percent, while the share of privately-controlled firms, including foreign firms, had risen from zero in 1978 to almost 80 percent. The falling share of state firms is explained by two factors. First, their return on assets has been persistently below that of private firms. Since most investment in China in the past two decades has been financed from retained earnings, relative to private firms state firms have been less able to reinvest. Second, as already noted, banks have increasingly provided loans to the more productive private sector so lending to state firms has fallen in relative terms.

This transformation is reflected in figure 4, showing that the composition of fixed investment in manufacturing has been largely transformed. By 2012 privately controlled firms accounted for almost three-quarters of investment and the share of investment by state firms had fallen to only 11 percent. In contrast, in the service sector where there are still numerous barriers to entry by private firms the share of investment undertaken by state firms, shown in figure 5, has declined only slightly in recent years and is fully four times the share of state investment in manufacturing.
In summary, the credit driven growth path of the recent past in China is clearly not sustainable. But a financial crisis is not inevitable. But China needs to moderate the growth of credit. If at the same time deposit interest rates are liberalized and previously state monopolized industries, particularly those in services, are opened up to private investment more funds will flow to private firms. Since these firms have returns on assets that on average are more than twice those of state firms, this reallocation of credit will be growth enhancing and allowing China to maintain fairly rapid economic growth with a substantially lower share of resources devoted to investment as compared with recent years.


2PrasenjitBasu, “China’s crisis is coming—the question is only how big it will be,” Financial Times, April 28, 2014, p. 7.


In this paper state firms refers to the universe of traditional state-owned companies and state firms that have been corporatized but where the state remains the majority or dominant shareholder.

The data on private firms shown in figure 3 is for registered private firms only. However, I believe that these returns reflect returns in the broader universe of privately controlled firms, including limited liability and shareholding limited companies where the majority or dominant owner is private. In 2007, a year for which complete data are available, the gap between the return on assets in the narrow universe of registered private industrial firms, 9.5 percent, and the universe of industrial firms in other registration categories that are privately controlled, 8.3 percent is relatively small. The return for the entire universe of domestic private firms was 8.9 percent. Thus using returns of registered private firms as a proxy for all private firms overstates returns by 0.6 percentage points or only 7 percent (= 9.5/8.9).

Typically the cost of capital for firms is calculated as a weighted average of the cost of debt and the cost of equity, the latter measured by the return that an investor would expect from holding a company’s shares. But in China few companies are listed on the stock exchanges and the corporate bond market is extremely small. Thus, other than retained earnings, most capital in the corporate sector comes from bank loans. So the interest rate on a one-year loan is assumed to be a reasonable estimate of the cost of capital. To the extent that state firms rely on funds from non-bank lenders in the shadow banking sector where interest rates for borrowers are typically higher, the approach adopted here understates the degree to which the return on assets of state firms falls below the cost of capital.