

Research

November 21, 2006

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Global: China's growth miracle - is it sustainable?

- In this note, we attempt to make a judgement as to the sustainability of the Chinese growth model. We question whether China's investment boom continue, or face the risk of a financial meltdown as we saw in Japan in 1990 and East Asia in 1997-1998? We also scrutinise whether China will be able to move further up the value chain, which is essential to maintain high productivity growth.
- We argue that on a 10-20 year horizon corporate investment growth is likely to slow as the industry intensity of China's economy falls. Moreover, household savings will fall in the long term due to: 1) a build-up of the social safety net; 2) financial liberalisation, and 3) the ageing of the Chinese population. But again this may be more of a 10-20 year story rather than something which will happen over the next decade.
- The weak link in the Chinese economic model is the state's interference in the lending decisions of the state controlled banks, and the lack of effective corporate governance - which implies that state owned corporations, may be investing inefficiently. The inefficient financial model is not a problem at the moment as the banking sector and the state-owned firms are effectively guaranteed by the state. But as the state loosens its grip on the banking sector, a crash cannot be ruled out.
- What is ultimately driving the sustainability of China's investment boom is whether China's productivity growth will continue. China is still such a backward country in many ways, implying that if the reform process remains on track then the productivity catch-up is likely to continue for many years. One big risk is more severe backlash on protectionism. If the protectionist steps from the EU and the US broadens in scale it may slow down FDI. This could have a significant effect on China's productivity growth.

China's challenges

China in the future

China's growth over the past 26 years has been staggering. This note is the second in our series of reports concerning China in the global economy. In the first "*Research - Global: Asia's growth miracles - is China different?*" of 25 October, we argued that at first glance there is not much difference between the catch-up process in China to date and those previously seen in Asia. But two

features stand out: China has experienced even stronger capital accumulation and even faster productivity growth than other Asian economies. The drivers have been high savings and very high FDI which have fuelled a very competitive export sector.

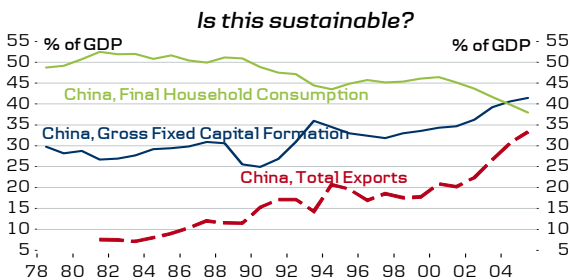
In this second note, we look forward and attempt to judge whether the Chinese growth model is sustainable. The first question to ask is whether China's enormous investment boom will continue. Can China's investment continue to grow at a rate of

20-30 % y/y, which has been the average over the last 10 years? Or is there a risk of a financial meltdown as we saw in Japan after the bubble burst in 1990 and in the East Asian crisis in 1997-1998. The second question is whether China's relatively high productivity growth will continue. After having "copied the whole world," will China be able to move further up in the value chain - which is essential, in our view, to maintain high productivity growth and a competitive export sector?

Is the investment boom sustainable?

Scary numbers

Looking at the rough numbers, one may get a bit nervous. Investments' and particularly exports' share of GDP have risen enormously, while the share of consumption has continued to fall. Unless China is set to be a tremendously open economy relative to its size, and/or investment to GDP will be able to reach an unprecedented level, export and investment growth will eventually have to slow.¹



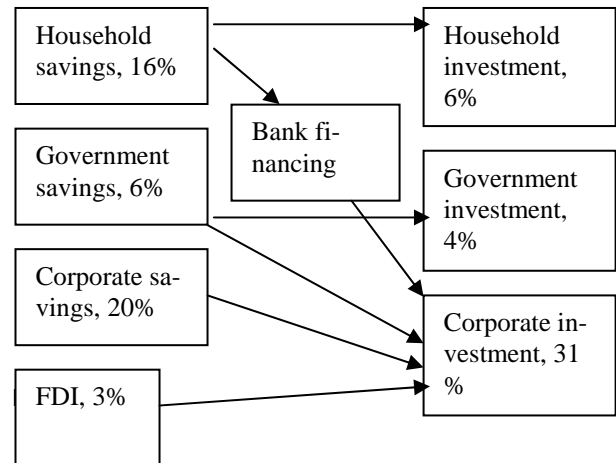
In previous cases (cf. "Research - Asia's growth miracles - is China different?" 25 October) the investment ratio started to slide 20 years into the catch-up process when the investment ratio reached a level of around 35%. China's current level of investment and its 26 years of very rapid economic growth suggest that China's investment ratio could be approaching its upper limit.

¹ Many observers argue that the Chinese investment data are overstated. Fixed asset investment data are only reported in nominal terms and includes land sales. With the last years' boom in the Chinese real estate market and rising commodity prices fixed asset investment are likely to overestimate investment in the Chinese economy. National account data on gross capital formation which does not include land sales is better comparable internationally. However, the huge current account surplus suggests that either the savings data is underestimated or the investment data is overestimated. But no matter whether the Chinese investment data is overestimating investment it is difficult to reject the claim that China's investment is growing rapidly and is currently at a very high level.

Is China's savings /investment balance sustainable?

To judge whether China's investment ratio is sustainable, we first break down China's savings and investments into the various sectors of the economy. Compared to other countries, household and government savings are at a very high level in China and corporate savings have increased strongly in recent years as profits have surged. On the investment side, corporate investments are driving the investment boom in China. As the chart below shows, the extremely high corporate investment ratio is largely financed by retained earnings. Actually two-thirds of corporate investment comes from this source: while the household sector is a high net saver, this flow is half as big as retained corporate earnings.

Corporates are driving the investment boom

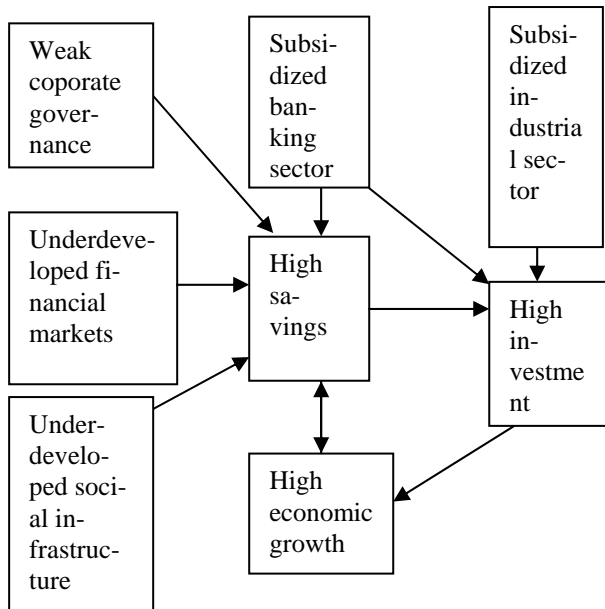


² Source: Louis Kuijs "How will China's saving-investment balance evolve?" 2006 World Bank China Office, Working Paper 5. The figures are as a percent of GDP.

Rapid economic growth has together with a lagging financial development and lack of social infrastructure created the mechanism for very high savings in China. The government's subsidies of the industrial sector and the banking sector have stimulated the transmission from high savings into high investment, particularly in large corporations and state-owned enterprises. As an example, more than half of total bank credit comes from state controlled banks and nearly 50% of China's total fixed asset investments comes from state-owned or state controlled units. These state-controlled banks and state-owned firms do not have a pure profit motive. The incentive to give back earnings to the owners is limited, compared to the incentives to reinvest profits. The outcome is an economic model where there is a strong stimulus to savings and investment but widespread resource inefficiency is plaguing the system. The crucial questions

are whether savings will remain at their current high level and whether the resource inefficiency is a risk for the whole financial system?

China's savings-investment mechanisms

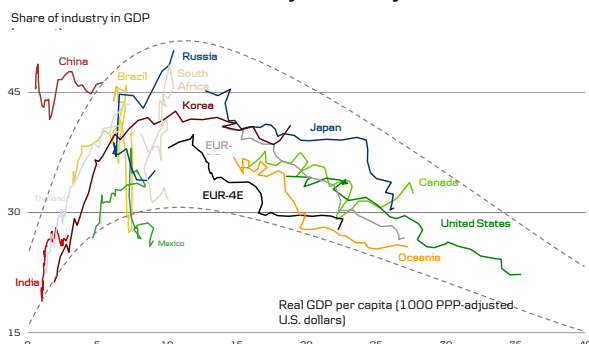


Corporate investment is driven by the industry

One important structural reason for China's current high corporate investment rate is the industry intensity of the Chinese economy. There is a tendency for more industry intensive economies to have higher corporate savings and investment. This is because the industrial sector is very capital intensive. In China, this is exacerbated by the weak corporate governance and a lack of dividend rules as mentioned above.

Compared to its stage of development, China is a very industry intensive economy. Experience tells us that as people get richer the service sector will start to play a bigger role in the economy. However, as the figure below illustrates China is still not at an income stage where this process starts in earnest. Hence, this may be more of a 10-20 year story than something which will happen over the next 10 years.

China is extremely industry intensive



³ Source: IMF (2006)

Economic policies are also likely to imply redistribution of resources from industry to the service sector in the coming decades. In its striving for building a more resource efficient and 'harmonious' society, the Chinese policymakers will try to stimulate the more labour intensive but less resource intensive service sector of the economy. One adjustment could be to shift from government investment to government consumption on, for example, health care and education. However, this is likely to be a slow moving process.

A further reason why corporate investment is likely to slow over the coming decades is based on more cyclical reasons. China has since the end of 2001 experienced a very strong boom. The boom has both been driven by a very strong expansion in the global economy and a very strong push to China's trade coming from the WTO membership in December 2001. This has naturally stimulated corporate profits and hence new investment. However, the past five years will not be the average over the coming decades and hence corporate investment in China will fall for pure cyclical reasons.

Structural reasons for household savings to slow

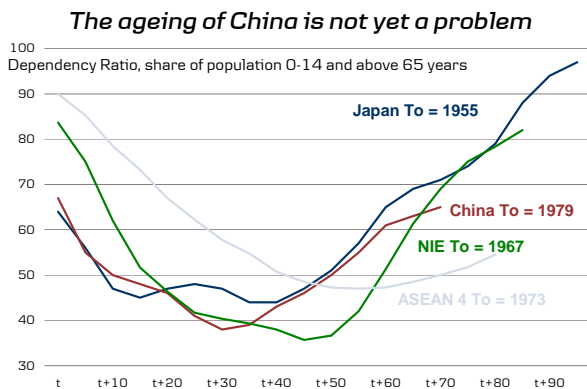
The second biggest source of savings is the households. There are also several structural reasons why household savings in China are likely to slow in the longer term.

1) Chinese policymakers have indicated that they are keen to improve the social benefits in the country, particularly targeted at people living in rural areas (including free compulsory education for children in the rural area and expanding the rural health care system). However, this is not likely to have a major effect on the short term as the initiatives are mainly targeted at the rural poor. In the longer term, when the policymakers also improve the social safety net for the middle class it should reduce the precautionary savings motive for household.

2) Many households (and also some corporates) are still credit constrained, fuelling high savings. With financial liberalisation to move ahead in the coming decades less people and corporations should be credit constrained thereby lowering savings. Also, improved corporate governance and en-

forced dividend policies for SOE's are likely to lower corporate savings in the longer term.⁴

3) Finally, demographic factors should also reduce savings as the average age of the Chinese population increases, partly due to the one-child policy. However, as the graph below, which includes forecast for the dependency ratio until 2050, illustrates, the dependency ratio in China is actually likely to decrease over the next five years. The ageing of the population is not set to really bite in the next decade. However, longer term this should result in lower savings.



⁵ Source: UN forecast until 2050

The risk of a financial meltdown

Comparing with earlier Asian experiences

Now we explore in greater detail the financing of investment in China and the risk of a financial meltdown. One may interpret the end of Japan's catch-up process in 1990 and the East Asian crisis in 1997-1998 as outcomes which finally proved the inefficiencies of the Asian financial system. The crises had a long lasting effect on investment ratios in the countries involved and hence on economic growth. Could something similar happen in China?

Before further scrutinizing the Chinese case, let us first highlight the main reason behind the burst of the bubble in Japan in 1990 and the East Asian crisis in 1997-1998:

- Large speculative capital inflows which created the 'conditions' for a financial panic as soon as investors started to lose confidence in the economies and the financial systems. With semi-pegged currencies

⁴ See Louis Kuijs "How will China's saving-investment balance evolve? 2006 World Bank China Office, Research Working Paper No. 5. for further discussions.

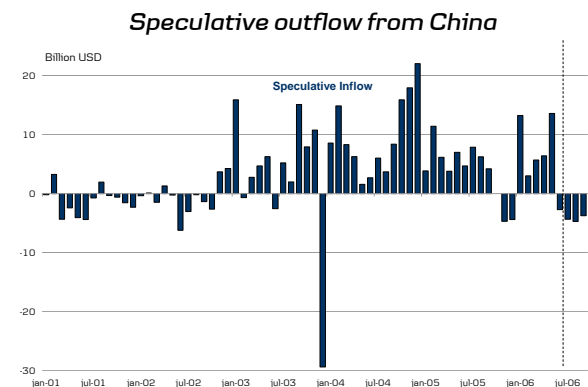
the financial panic translated into currency and banking crises (East Asian crisis).

- Inefficient banking systems which through directed lending guaranteed by the state financed inefficient investment. This created the 'conditions' for a spiralling process, going from reckless lending - asset inflation - burst of bubble - asset deflation - banking crisis (both present in the Japanese crisis and in the East Asian crisis).

A financial panic is not a risk...

Some observers argue that China may at some point face the risks of destabilising capital flows risking a currency crisis, which could then translate into a banking crisis. That could unfold if the Chinese authorities try to defend a still very dollar-pegged currency at a time when the appreciation expectations are shifted in favour of depreciation expectations.⁶

Despite China's substantial capital controls, it has in recent years faced significant speculative capital inflows partly driven by expectations of appreciation of the renminbi. Over the past months the speculative capital inflow has in fact reversed to a capital outflow. The driver has been a significant portfolio outflow. Is this a trend and is it something to be concerned about?



In our view, it is likely that in the years to come we will see a continuing speculative capital outflow from China, partly encouraged by the Chinese authorities to mitigate the upward pressure on the renminbi. However, sudden capital outflows are, in our view, definitely not something we should worry about. With fx reserves above USD1 trn, or 15 times monthly import and booming current account surpluses, it is difficult to see a speculative run on

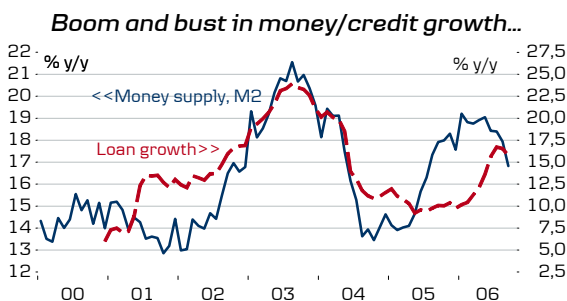
⁶ See e.g. Franklin Allen et al., 2006, "China's Financial System: Past, Present and Future", mimeo The Wharton School.

China's currency as we saw in the East Asian crisis. Moreover, in the longer term the Chinese authorities have learnt from the experiences of East Asia and will only slowly liberalise short term capital flows. Therefore, we will not have fully flexible capital flows before we have a very flexible currency. This lower the risk of a 'financial panic' type of crisis as we saw in East Asia.

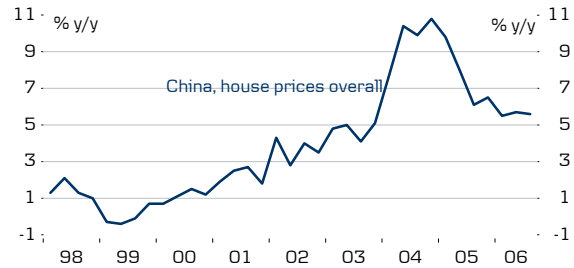
...but a boom-bust in asset prices cannot be ruled out

It is, however, a fact that the other main reason behind the East Asian financial crisis (and the Japanese crisis) – an inefficient and distorted banking system which created the conditions for a boom and burst in asset prices – is also evident in China. In fact, we would argue that the state's interference in banks' lending decision and the lack of credit culture in the banks is probably even more pronounced in China, with the four large state-dominated banks accounting for more than half of the total bank credit. Moreover, weak corporate governance implies that a flood of free cash flows in state owned corporations may be translated into inefficient investment.

As has been evident over the past years, the authorities have faced severe challenges in controlling money supply and bank credit growth, which have fed into the real estate market. If China continues to move so slowly on exchange rate reform and monetary policy reforms the authorities may have to continue to live with excess liquidity in the banking system and difficulty in controlling money/credit growth. This implies that future boom-bust outcomes in the real estate market and other asset market cannot be ruled out. This could have a feedback effect on the banking sector and hence on investment and the overall economy.



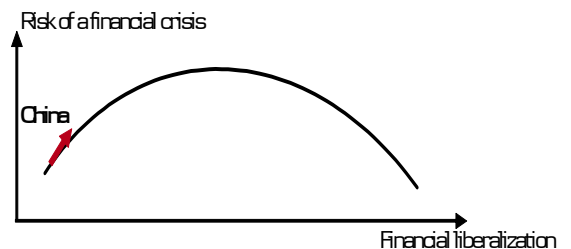
...has been driving a boom in real estate prices



However, the same problem, which makes the problem of state interference so deeply rooted in the Chinese financial model, also prevents a financial crisis. The state's guarantee to bail out banks if they run into trouble is definitely more credible in China than it was in East Asia where a lot of banks in, e.g., South Korea and Indonesia were closed after the crisis broke out. The reason is simply that the large banks are still to a large extent state-owned in China. The risks of a near-term meltdown of the banking sector in China is probably not that large given that the creditors know that the government will bail them out.

But as the government is set to loosen the grip on the banking sector in the coming years, partly due to WTO commitments, bank creditors may not any longer be so sure that the state will bail out the banks in case of troubles. In fact, in its striving for cleaning up the banking sector the Chinese authorities are likely to try to signal that state guarantees will not necessarily remain in place. Therefore, the banking sector may in fact become more prone to crashes in the future than they are now. Hence, the Chinese authorities face a difficult balancing act in the coming years.

The risky road to an efficient capital market



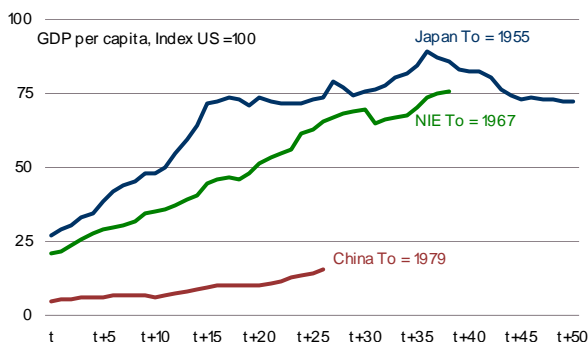
What is essential as the Chinese authorities are losing the grip on the banking sector is: 1) that the credit allocation mechanisms in the banks are greatly improved, and 2) that the role of the SOE's is reduced and that they are pressured to focus on profitability in its investment decisions. One may hope that China has learned from earlier Asian ex-

periences the importance of reforming the financial model before moving ahead with necessary financial liberalizations. If not, a banking crisis, which could have a long lasting effect on China's investment, cannot be ruled out.

Is China's productivity boost set to continue?

Ultimately, what is decisive for whether China's investment boom is sustainable and whether the financial model is at risk, are whether China's productivity gains will continue. We would argue that most likely China's productivity catch-up will continue. China is still in many respects a backward country, implying that if the reform process remains on track the catch-up is likely to continue for many years. As we argued in *Research - Global: Asia's growth miracles - is China different*, of 25 October, China still has huge potential to shift labour out of agriculture and into higher productivity sectors such as industry and service. Moreover, although China has been moving fast up in the value chain within many industrial goods China still has a long way to go compared to, eg, Japan and South Korea. Finally, continuing privatisations of many state-owned corporations in the coming years should enhance productivity.

The catch-up potential is still enormous



In our view, one of the main risks for China's productivity catch-up over the coming decade is a more severe backlash on protectionism. As we argued in our first note, the deep involvement of foreign firms in China's export-oriented industries can go a long way to explain China's relatively fast productivity growth until now. China clearly faces enormous challenges in improving the enforcement of intellectual property rights and lifting the protection and subsidies of different of China's own industries. But one may fear that even if China moves ahead with fulfilling its WTO commitments, US and

European politicians may find reason to be tough on China regarding trade. As long as large labour-intensive industries are at risk due to competition from China, and China continues to have such a large trade surplus versus the US, the political will to move ahead with protectionist steps towards China is high. If the Western world's trade sanctions versus China broaden in scale it will slow down FDI, export growth and hence put China's fast productivity catch-up at risk.

Political change is the highest risk

We conclude with some final remarks on the political development which we have left out of this note due to its complexity. Many argue that political unrest is on the rise in China. However, until now the social unrest is mainly targeted at the provincial governments where the focal points are rising income disparity within China and local provincial government's abuse of farmer's land rights. However, there is not really any significant unrest targeted at the top leadership.

But in the longer term, it is not at all clear that a communistic autocracy will be able to live together with a dynamic market economy.⁷ And a possible change in the political system in China may not be gradual but could in fact be very abrupt. That is, in our view, the biggest risk to the Chinese economy over the coming decades. Probably, the one thing which could unleash it is that the growing middle class in China really starts to get fed up with the political leadership. Slowing growth and a continuation of corruption scandals which is starting to hurt the middle class - could be the triggers. How such a crisis could unfold and how that will affect the Chinese economy is left for future research.

⁷ See Martin Wolf "China's autocracy of bureaucrats" *Financial Times*, 30 May 2006, for a further discussion.

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