# The Turning Point: First Steps toward a Post-Crisis Economy

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From the beginning, two questions have been asked about China's stimulus program: Would it work? And given that many measures taken would have costly long-run effects, would it be worth it? The first of these arguments is now over: The stimulus program worked, and reasonably broad-based growth is now apparent. A modest but unambiguous shift in macroeconomic policy has occurred in January 2010. However, with the return of growth, policy-makers now face a new set of problems that directly and indirectly reveal some of the costs and long-run harmful effects of the stimulus. This is already evident in the complex struggle to control bank lending in January 2010. Efforts to address potential problems are hobbled by a political leadership class that appears to be satisfied with the current situation and unwilling to tackle difficult problems.

## January 2010: The Turning Point in the Turnaround

A year ago, in early 2009, the magnitude of the Chinese response to the global financial crisis was just beginning to emerge. While the Chinese government had announced a robust stimulus plan in November 2008, it was at first unclear to what extent the government would actually fund the program. Thus, it was hard to tell what the ultimate stimulus impact of the program would be, and how quickly it might begin to have an effect on the macroeconomy. By February 2009 the answer was beginning to emerge: The stimulus program would be amply funded, because China's state-owned banks were opening the spigot to lending. An enormous surge of credit poured out of this system, particularly in the first quarter of 2009. Lending slowed a little bit after the first quarter, but just barely. For the year as a whole, lending was up more than 30 percent, in spite of the fact that even after recovery nominal GDP would grow by only about 6 percent (real GDP grew by more, but the overall price level fell during the year).

Massive monetary expansion on this scale makes everyone uncomfortable, but especially economists. The economic historical record is filled with cases of monetary expansion that looked good at first, but ultimately came to grief. Not surprisingly, China's credit-driven expansion had many critics right from the beginning. It is important, however, to distinguish between two categories of critics: Those who said the stimulus wouldn't work, and those who said that it might not be worth it, because its long run effects would be harmful.

First, what about the claim that the credit-driven stimulus wouldn't work? Those critics worried that money would pour into capital-intensive infrastructure projects, but these would generate little employment. Household consumption and private and non-state investment would not grow rapidly enough, in this case, to support a robust recovery. A variant of the belief that the stimulus wouldn't work was the skepticism expressed in some quarters about China's economic data when it began to show recovery. Skeptics claimed that there was a logical contradiction between electricity and growth figures; or that China's GDP calculation was defective because it was capturing output produced by government command that nobody was buying; or that government buying accounted for all the new vehicles being sold; or that it was impossible to have rapid credit growth, a growing economy, *and* falling prices.

This class of critics has been proven wrong. The stimulus program worked, and none of the supposed contradictions or shortcomings in the data proved to be true. Growth accelerated over the course of 2009. Quarterly GDP growth—compared to that same quarter one year earlier—went from 6.2 percent, to 7.9 percent, and then 9.1 percent and 10.7 percent in the fourth quarter. For the year as a whole, real GDP growth clocked in at 8.7 percent. The apparently smooth acceleration implied by these numbers is something of a statistical artifact, since the comparison with the year previous quarter essentially averages out the changes over the previous four quarters. If these growth data were expressed in terms of quarter-to-quarter growth rates, we would have seen the economy slowing almost to a halt at the end of 2008 and the beginning of 2009, and then starting to bounce back quickly by mid-year. China has gone through a classic V-shaped recovery. Other indicators are consistent with the GDP figures. Of these, the most important are trends in employment. The data with respect to employment are extremely poor, but a few indicators are telling. Economists at the Institute of Agricultural Economics who regularly survey rural labor markets and rural-urban migration found that the number of working migrants surpassed previous highs in June 2009, after sharp declines at the beginning of the year. Yang Yiyong, one of China's best economists tracking labor trends, estimated that aggregate employment increased 8.5 million in the first three quarters—compared to a full-year target of 9 million that was once considered over-optimistic—and continued to grow rapidly in the fourth quarter.[1] Thus, as the fourth quarter 2009 began, most Chinese economists were beginning to feel more comfortable with the fact of recovery.

During the last two months of 2009, though, the economy seems to have accelerated further. We see evidence in many ways, but two pieces are particularly relevant. The Purchasing Managers' Index, which measures month-to-month changes in the economy based on firms' responses to a questionnaire, climbed to its highest level since April 2008, reaching 56.6 in December (anything over a 50 indicates an expanding economy; the low point reached in November 2008 was 38.8). Most tellingly, the index for new domestic orders reached 61, indicating that businesses are increasing their purchases rather quickly. The other piece of evidence was the bump up in the consumer price index (CPI) to positive 1.9 percent over the year previous level, after being in negative territory since February. Obviously, 1.9 percent annual inflation is not a big deal, but the *increase* in only two months is striking.

Finally, the most significant confirmation that the economy is accelerating has come from the central bank, which has begun to tighten monetary policy and its control over banks. On January 7 the bank nudged up the rate it pays out on central bank notes (an interest-earning alternative to loans for the commercial banks), the first increase in interest rates since the crisis began. In case anyone could have missed the signal, five days later, the central bank increased the reserve ratio (the required proportion of its own deposits a commercial bank must keep at the central bank). Moves such as this send what economists call a "costly signal." They display the central bank's intent, but they also have real costs, in that they reduce commercial bank profitability and spook markets (and indeed Shanghai's stock market is down about 9 percent in January). If recovery is fragile, the bank would hesitate to take such steps. The fact that the bank is willing to take such steps shows that the bank is worried about overheating, and perhaps inflation, and is willing to pay costs to start to bring those dangers under some kind of control. Thus, January's turn in macroeconomic policy marks a clear turning point as monetary policy has begun to become less expansionary. At the same time, it marks a clear confirmation that the previous policy of massive stimulation of the economy "worked," in the simple mechanical sense that the flood of bank credit did work through to the real economy, stimulated demand, and kept the economy from going into a much worse recession than it would have, in the absence of such actions.

## Credit Policy, Inflation, and the Real Economy

The Chinese banking system began pumping vast quantities of credit into the system in January 2009. In a market economy, we expect monetary policy to have its biggest impact on output and the price level about a year to 18 months later. In China, the lag effect might be shorter, because so many investment projects were rushed into construction as quickly as possible. According to the macro model that Song Guoqing of Peking University's China Center for Economic Research has estimated, the lag between monetary changes and inflation in China is 11 months, with some evidence that it may have become shorter since 2000. That means that right now is the time when you would expect the greatest inflationary impact from the credit surge of the first quarter of 2009. Song—one of China's most creative and respected macroeconomists—expects inflation for 2010 to be above 3 percent, and possibly above 5 percent on an annual basis (implying a difficult mid-year period where it is above the 5 percent "red line").[2]

More generally, China's economists are worried about inflation, but don't yet believe that it has arrived. According to a survey of 62 economists and entrepreneurs conducted in December (before the December spike in the CPI), 56 percent felt that clear inflationary expectations had formed, but inflation had not yet clearly emerged; 33 percent felt that inflation had arrived. Only 11 percent felt that inflation was not yet a problem.[3] The new journal edited by Hu Shuli, who famously lost control of the brilliant *Caijing* last year in a murky political/business dispute, devoted one of its first issues to a dissection of the inflation topic. The question is clouded by many technical issues. On the one hand, December's jump in prices was primarily driven by food prices, which in turn were mostly caused by bad weather. These are not very likely to be sustained. On the other hand, the CPI gives a disproportionate weight to food prices (34 percent), which is no longer appropriate, especially in the cities. Manufactured goods make up 40 percent of the index. All components related to housing make up only 14.7 percent, even on a very inclusive definition that takes into account gas, water and electric, building materials, and a tiny component for rent and mortgage interest rates.[4] This clearly understates the role of housing costs in expenditure, at least in urban areas. Moreover, in recent months there have been increases in water, electricity, and gas rates in most cities.[5] Thus, the CPI is more likely to understate the "true" inflation rate than it is to overstate it.

For the short run, the meaning is clear. Expectations of inflation have dramatically increased, because economists and the general public see the huge run-up in housing prices (not reflected in the CPI) and the beginnings of increases in other prices (that are reflected in the CPI). The mainstream expectation is that the CPI will increase by about 3 percent in 2010. This would raise some eyebrows, but most people think that a movement toward 3 percent inflation that was not too abrupt would be a good thing, not least because it would make relative price adjustments easier. In the survey of economists and entrepreneurs mentioned earlier, 62 percent felt that inflation in the 3–5 percent range was acceptable, if China was growing robustly; another 15 percent felt that 5–7 percent inflation was acceptable.[6]

Political leaders also have their own level of inflation tolerance. We have observed over the past 20 years that leaders do not want inflation to surpass 5 percent. (In the past, both Zhao Ziyang and Li Peng were deposed as premier when inflation surpassed this.) When inflation goes over 5 percent, Chinese policy-makers take action. Those actions include tightening monetary policy, of course, but they have on occasion also included appreciation of the RMB. The last time inflation passed 5 percent was in mid-year 2007; within a few months, significant RMB appreciation began. There is no clear signal that RMB appreciation will resume in 2010, but *if* it does begin, it will most likely be in the wake of a surge of inflation at mid-year.

From one standpoint, then, the beginning of 2010 corresponds to an ordinary policy turning point. After a year of counter-cyclical, extremely expansionary monetary policy, policy-makers are now starting to tap on the brakes. The pace of the shift to a tighter policy is, however, unusually hard to judge. As we will discuss at the end of this piece, the top political leadership has not given permission for a significant change in monetary policy orientation. Moreover, there is not yet a clear danger of immediate inflation, so bank policy-makers are taking a wait-and-watch attitude. Finally, there is a general worry that the global and Chinese recoveries are still not firmly in place, and therefore that premature withdrawal of stimulus could be quite harmful. But, given strong growth, this shift in policy shows that the stimulus policy "worked," in the sense that it kept China out of a potentially devastating recession.

## Deeper Problems with Stimulus and the Chinese Economy

Although the stimulus worked, it was costly. At a minimum, it distorted the Chinese economy by halting, and temporarily reversing, the decades-long trend for the state to retreat from the economy, and for private and non-governmental actors to play a greater role. This was harmful not solely or even primarily because the state sector is "inefficient" or "backward," but rather because these actions profoundly disrupt the incentive structure that applies to both private and public actors. As long as the scope of the state sector was basically known and the trend both inside and outside the state sector was toward more profound marketization, individuals were rewarded for maximizing benefits according to market-determined prices and rewards. However, once the scope of the state sector is indeterminate; and administrative interventions are repeatedly re-drawing the boundary between state and private; then individuals must devote a great deal of their attention to anticipating and manipulating those administrative acts. This new environment changes calculations and increases costs even for efficient outcomes: more important, it increases rent-seeking opportunities and produces many more inefficient outcomes. Some of these outcomes were described in my previous *CLM* piece, using the steel industry as an example.[7]

We now see that these incentive problems have already spilled over into the management of the monetary sector. For the past several months, the two agencies responsible for banks and monetary policy—the China Bank Regulatory Commission (CBRC) and the People's Bank of China (PBC)—have been struggling to bring bank lending under control. Since July 2009, at the latest, monetary authorities have been deeply concerned about the overly rapid pace of monetary growth. The two agencies have handed off responsibility back and forth, with the CBRC mostly taking the lead in summer 2009, and the PBC taking the lead now. However, their attempts to rein in credit growth have met with extraordinarily uneven results. One part of this, to be sure, is due to the fact that policy-makers don't want to spook markets by moving too abruptly. Through the second half of 2009 they tried to slow lending without taking strong moves like raising interest rates and reserve ratios. They did this primarily by administrative guidance, and by tightening capital adequacy requirements. The result was something like trying to compress a balloon: While the regulators tried to squeeze, spurts of new lending kept coming out in unexpected places. The pace of lending stayed high, though not at the astronomical levels of the first quarter.

The problem is that the incentive environment banks face has changed greatly in the past year. With the government and the Communist Party strongly behind a raft of investment projects, banks have little reason to worry about risk. Since these are government projects, the government implicitly guarantees the risk if they go bad. After a decade of progress in the other direction, bank budget constraints are now "softening." As a result, each individual bank has the incentive to grab as many of the best projects as possible, in order to lock in interest payments and the multi-year stream of business. Moreover, banks have a great incentive to game the administrative controls that bank regulators have been more or less forced to use. A surge of loans positions the bank to defend a higher overall level of lending: the faster the better. It is an incentive system, and a system dynamic, that is familiar from the planned economy.

This implicit dynamic has become very evident in January 2010. As monetary policy has quietly turned a corner, banks have increased their efforts to make sure they get a good piece of the (now potentially limited) action. At the end of 2009, bank regulators made a special effort to keep aggregate lending under control, so the annual data wouldn't look so bad. They managed to keep annual loan growth to 9.59 trillion RMB (rather than 10 trillion). However, the result was that banks had a backlog of projects they wanted to lock in. Moreover, the banks could see that monetary policy was just beginning to tighten, so that projects not started quickly faced a real danger of never being funded. The result was that during the first 10 days of January, a total of 600 billion in new lending went out; and in the first *two* 10-day periods, about 1.4 trillion.[8] This means that after several months of being more or less under control, bank lending in January is now set to soar and approach the astronomical figures of the first quarter of 2009.

Needless to say, central bank authorities are not happy. They have responded by imposing a raft of lending freezes and new controls on banks, while denying that quantitative bank lending quotas have been reimposed. Individuals buying homes who had completed their mortgage process were suddenly informed they had to wait until the next month to actually get their money.[9] Some banks reported that they were told to stop all lending for the rest of January. The Bank of China was reported to have been told by the CBRC that their annual lending should fall to 650 billion in 2010 from 1.1 trillion in 2009, although the CBRC denies having set such a quota.[10] The State Council is said to be monitoring loan volumes on a daily basis (usually they just review the monthly numbers).[11] The PBC and CBRC say they are primarily interested in smoothing the emission of lending, and suggest they will plot the growth of daily lending from individual banks, looking for a smooth curve. They are backing this up by imposing penalty reserve requirements on banks that are clearly out of compliance.[12] Each side is trying to outmaneuver the other.

Eventually, the banking system will work through these behaviors. However, they are costly: They take up the time and attention of managers during a critical period for the economy, they end up with lots of bad projects getting funded, and most importantly, they create uncertainty for the marketplace over where China's macroeconomic policy will settle. This is one immediate cost of the large-scale advance of the state in China during the last year. Of course, there are many others, many having to do with the increasingly unbalanced state of the Chinese economy, with its extreme dependence on investment and large trade surplus. And lying behind these problems is the failure of China's political leadership to really take these problems seriously.

## Conclusion: Economic Work Conference December 2009

Each year in early December, economic policy-makers and top political leaders gather at the Economic Work Conference, which sets the main contours for economic policy in the coming year. This past December, the basic policy laid out was to maintain continuity in policy—continue expansionary fiscal and monetary policy—while doing more to adjust the structure of the economy and the growth path. To be sure, the Work Conference laid out a number of policies that show they recognize the potential costs of continuing the unbalanced growth process worsened by the stimulus package.[13] The meeting called for an improved growth model that emphasized efficiency rather than just quantitative growth; for an increased push to provide more low-cost housing; and for further integration of rural migrants into small and medium-sized cities (so that they would be eligible for improved social services as citizens). Perhaps most interesting, the meeting called for lower entry barriers for private businesses into sectors dominated by the state. These are all good ideas that could be part of a shift toward self-sustaining, consumption-led growth that is much less imbalanced.

The problem is that so far there is little evidence of any significant political will to really change the patterns embodied in last year's growth. On the contrary, there are strong political forces that benefit from government patronage and extension of government power, and those interest groups do not show the slightest sign of being in retreat. The Chinese government, headed by Premier Wen Jiabao, has made many statements about their intention to move toward more balanced growth, since at least 2004. But it hasn't happened. This continued failure to tackle some hard issues, trim back the power and resources controlled by the state, and open up more of the economy to ordinary people has made most economists increasingly frustrated. It appears that the Chinese economy will have to encounter some kind of short-term crisis before the government will contemplate taking the steps necessary to adjust its policies. It is very difficult to get change out of a political system that seems to be succeeding so brilliantly on its own terms.

## Notes

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[2] Song Guoqing, "*Zhuanjia riyi 2010 nian Zhongguo tongzhang*" [Expert surprises audience with 2010 China inflation prediction], *Jingji Cankaobao*, January 21, 2010, accessed at http://money.jrj.com.cn/2010/01/2106486844554.shtml.

[3] Xie Wenyu, "*Zhongshi baiming jingjixuejia ciyejia dadiaocha: tongzhang li women hai you duoyuan?*" [Central TV Surveys 1,000 Economists and Entrepreneurs: How far off is inflation?], *Jingji Banxiaoshi* [Half an Hour of Economics], December 4, 2009, accessed at http://space.tv.cctv.com/article/ARTI1259973873713334.

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[5] Liu Jingjing, "*Shuijia shangzhang nian*" [The year of rising water prices], *Xin Shiji*, January 4, 2010, accessed at http://magazine.caing.com/chargeFullNews.jsp?id=100106588&time=2010-01-08&cl=115.

[6] Xie Wenyu, "*Zhongshi baiming jingjixuejia ciyejia dadiaocha.*"

[7] Barry Naughton, "Loans, Firms, and Steel: Is the State Advancing at the Expense of the Private Sector?" *China Leadership Monitor*, No. 30 (Fall 2009).

[8] The PBC only publishes monthly data, so these numbers are market rumors, but they are generally considered to come from reliable sources. There is an enormous amount of press coverage of this issue. See the two related pieces: Sun Jianfang, Cheng Zhiyun, and Hu Rongping, "*Huobi jinsuo xinhao mingxian; yanghang chongshi xingzheng gongju*" [Clear signs of monetary tightening; the central bank again uses administrative methods], *Jingji Guanchabao*, January 22, 2010, accessed at http://finance.ifeng

.com/news/special/jshbzc/20100122/1747319.shtml; Cheng Zhiyun, Liu Xin, and Ceng Fubin, "*Gebie yinhang chaoxun; jianguanceng nishe fangdai luxiantu*" [Some banks are speeding ahead; regulatory strata are considering imposing a lending curve], *Jingji Guanchabao*, January 22, 2010, accessed at http://finance.ifeng.com/bank/yhpl/20100122/1747305.shtml. See also Dinny McMahon, "China Banks Thrive on Loans: Beijing's Bid to Tighten Credit Is Complicated by Incentives to Lend Early, Often," *Wall Street Journal*, January 30–31, 2010, p. A16.

[9] Chen Chunlin and Shen Chunning, "*Nanjing duojia yinhang zhanting geren fangdai fangkuan*" [Many Nanjing banks have temporarily suspended individual mortgage disbursements], *Yangzi Wanbao*, January 24, 2010, accessed at http://finance.sina.com.cn/china/hgjj/20100124/05057299017.shtml; Liu Wei, "*'Tingdai' chuanyen yushi yinhang xindai shoujin*" [The rumor of 'Stop Lending' clearly indicates credit tightening], *Yangcheng Wanbao*, January 21, 2010, accessed at http://www.ycwb.com/ePaper/ycwb/html/2010-01/21/content_721034.htm.

[10] Liu Wei, "*'Tingdai' chuanyen yushi yinhang xindai shoujin*."

[11] Sun Jianfang, Cheng Zhiyun, and Hu Rongping, "*Huobi jinsuo xinhao mingxian*."

[12] Cheng Zhiyun, Liu Xin, and Ceng Fubin, "*Gebie yinhang chaoxun*."

[13] Liu Zheng, Ren Fang, and An Pei, "*Zhongyang Jingji Gongzuo Huiyi shifan wu da xinhao*" [Central Economic Work Conference gives five big signals], Xinhua, December 7, 2009, accessed at http://news.xinhuanet.com/fortune/2009-12/07/content_12606896.htm.