# Economic Uncertainty Fuels Political Misgivings

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Political uncertainty is inevitable as China prepares for this fall's leadership transition. This year economic conditions are also unusually unpredictable. In particular, while China is undergoing an inevitable economic slowdown, few have a clear idea of how drastic the slowdown will be, or how painful the transition to a slower growth path will be. Facing these multiple uncertainties, Chinese politicians are trying to leave themselves as much flexibility as possible.

With China's leadership transition only a few months away, it is inevitable that there would be great uncertainty about China's future policies and personnel. While the selection of the two top leaders has long been known, many important personnel choices have still not been made, particularly in the economic arena. Normally, we would have expected that top leadership meetings in the spring of 2012 would have laid out the main media themes and propaganda slogans for the run-up to the 18th Party Congress in the fall. This year, however, that seems not to have happened. Without guidance, Chinese official media today are even more vacuous than usual. Doubtless the Bo Xilai affair preoccupied leaders during the spring and disrupted the orderly transition process. However, economic conditions have also contributed to a heightened uncertainty. The sense of economic disquiet can be understood as deriving from both a short-term challenge and a deeper, long-term structural problem.

## The Short-term Challenge

China's economic policy-makers got an abrupt shock when the economic data for April 2012 arrived. For over a year, their primary task had been bringing down inflation.[1] Moreover, they seemed to have been doing a good job, as the inflation rate gradually declined from its peak of 6.5 percent in July 2011 to a more acceptable 3.6 percent in March 2012.[2] More crucially, the inflation turnaround seemed to have been achieved at a moderate cost in terms of slowing growth. Quarterly GDP data showed the economy gradually easing from over 10 percent growth in early 2010 (the recovery from the global financial crisis) to around 8 percent growth in the first quarter of 2012, an entirely acceptable cost. In other words, a "soft landing" looked to be in sight. The most important task seemed to be simply to stay the course.

This assumption was overturned by the April numbers, which showed a simultaneous deceleration in all the key elements of the economy. Industrial output from March to April grew at a rate that, converted into an annual growth rate, was only 4.3 percent. Fixed investment growth (again month-to-month but converted to an annual rate) dropped to 9.6 percent. Exports, imports, and housing investment all slowed dramatically, such that each was less than 5 percent above the figures for the same month a year previous.[3] These numbers were quite shocking. Almost immediately, the central bank's policy stance shifted. From fighting inflation, the bank became concerned with preventing an abrupt drop in growth. The bank had been ratcheting back growth in bank loans, but now began to promote loans to support investment and overall economic growth. Central bank interest rates were cut twice, on June 8 and July 6.

In the event, May and June numbers were more stable than the April data had led many to fear would be the case. Some analysts believe that China has reached the turning point, and that growth will stabilize, and even accelerate, in the second half of the year. The optimists' rationale for this outlook is essentially their prediction that investment will recover. Latent demand for housing is still huge in China, although it has been temporarily suppressed by government policy. As soon as the government signaled a new attitude toward growth and bank lending—and despite repeated declarations that controls on housing purchases and prices had not been relaxed—consumers rushed back into the housing market and began to again push up housing prices after nearly a year of reductions.[4] Many local investment projects have been suspended by auditors in the past year and a half, and local government "funding platforms" were audited and separated into categories of healthy, not-so-healthy, and very sick. The ability of these funding platforms to raise money by issuing bonds or short-term commercial paper was severely curtailed. These restrictions are relatively easy to reverse. Indeed, local funding platforms are already being allowed to return to the bond market, and restrictions on other types of capital raising are being gradually reduced.[5] Taken together, these measures can prevent growth from dropping too quickly in the short run, and should be able to maintain growth over the next year or two.[6]

Other analysts believe that short-run fixes will not do much for the economy. Pessimists point to an apparent deterioration in the quality of economic reporting. As local governments scramble to keep their own local growth rates from falling below 8 percent, there has been increasing evidence of falsified and misleading data.[7] Pessimists look at indicators that measure output in physical units, which they argue are less susceptible to manipulation. They claim that these can only be explained by an overall growth rate that is substantially lower than that indicated by official figures. Electricity production in June 2012, for example, was exactly the same as in June 2011, for a growth rate of zero.[8] The pessimists point out that prices are falling (on a month-to-month basis), and profits are declining as well. Optimists, in turn, reply that the data are not as simple as the pessimists imply. The investment slowdown, combined with firms unloading stockpiles, means that heavy industrial production—which drives electricity production—can slow down much more rapidly than the overall economy. They point out that pessimists have just as much difficulty explaining the robust growth reported in some sectors as optimists have in explaining slow growth in, say, electricity. The only completely sure conclusion at this point is that confidence in Chinese economic data has rarely been lower than it is today.

Perhaps more importantly, the pessimists point to a profound contradiction that even many optimists acknowledge. This contradiction is that all of the short-term fixes the optimists see propping up China's growth this year will end up contributing to China's economic problems in the long run. Short-term growth can be achieved, but it may be at the cost of abandoning efforts to rebalance China's economy. For example, if housing prices are allowed to soar again, investment funds will certainly be drawn into the housing market, propping up growth. However, this risks re-inflating an economic bubble, and contributing to deeper problems down the line. Moreover, a housing bubble of this sort would have profound political consequences: not only would many Chinese households find themselves priced out of the housing market, in addition, one of outgoing premier Wen Jiabao's most cherished programs would stand revealed as a bust. Similarly, the reason the borrowing capacity of local government funding platforms was curtailed in the first place was that there were serious worries about the capacity of many of these entities to repay their loans. Such concerns have not gone away. Permitting more borrowing today will simply postpone the day of reckoning, and probably create a worse financial crisis down the road. Similar concerns are relevant to every policy approach that increases government investment. Railroad investment, for example, has been partially restored, after having been heavily cut in 2011.

There are ways to support a healthy growth recovery, but they take time, persistence, and political will. The banking system has been engaged in a heavily publicized campaign to support lending to small and micro enterprises, and this has long-term promise. Reducing monopoly privileges granted to state firms and lowering barriers to the entry of private firms can create new growth sectors and regions. There are many available policies of this kind. However, none of these policies can work quickly enough to stabilize growth in the short term. Only increases in government-sponsored or -funded investment have the potential to achieve that end. To be sure, nobody expects a massive government-sponsored stimulus program of the kind China launched in 2008–2009. That would make it all too obvious that China was deferring the solution of all problems until a later period. Instead, the middle of 2012 will see a complex mixture of policies, some designed to reform the economy and open it up domestically, and others intended to quickly reinstate moderate growth of government investment. Optimists argue this mix will be sufficient to keep growth moderately strong through year-end, while pessimists think the real growth rates will come in substantially lower.

All sides agree that China is facing a growth slowdown. Moreover, to a remarkable extent, all sides agree that the pace and duration of the slowdown is unusually hazy and uncertain. This is due in part to external factors: economic conditions in Europe are the biggest single contributor to the slowdown in Chinese exports. European developments have proven remarkably resistant to commentators' projections, and Chinese exporters have little basis for good predictions. But there is a more fundamental reason: China is moving out of the long-term phase of very high growth. Almost nobody believes that there is a set of economic policies that can restore China to the 10 percent or higher growth rates that have characterized the last 30 years. There is no going back, and yet there is no agreement of what the "new normal" might look like.

## Long-term Slowdowns

It is clear that China's high growth phase has been an epochal event, reshaping global economics and politics. Over the past 35 years, China's economy has grown faster, longer, than any other in world history. Remarkable as China's achievement is, it also echoes the experience of other "growth miracles," particularly those in East Asia. Ever since Japan grew at an average rate of 10.4 percent between 1950 and 1973, we have understood the kind of growth that economies are capable of. The Japanese miracle was followed by a Taiwan miracle and a Korea miracle, and by super-fast growth phases in many economies around the world. These growth phases occur when societies are able to invest enough to enable the rapid transfer of underemployed workers from low-productivity agriculture to urban services and industry, and tend to be accompanied by a "demographic dividend," that is, a period when populations have an unusually large number of young adults, and few (young or old) dependents. A virtuous cycle of high saving and investment, rapidly increasing education, and rapid occupational change means that economies can change their structure very quickly. With this kind of underlying change, economies can grow at 10 percent or more for 25 years, or even a little longer.

The historical experience of these other growth miracles shows that all high growth periods must come to an end. At a certain point, the growth payoff that you can get from moving young people into new occupations quickly starts to fade, and growth rates drop. The process occurs differently in each economy. Often it is triggered by some kind of crisis: the Japanese growth miracle ran into the first global energy crisis in 1973, and Japanese growth dropped more than five percentage points. Never again did the Japanese economy grow faster than 6 percent in a single year. The Korean story is different in every particular detail, but similar in the sense that the growth slowdown was associated with an extremely difficult adaptation process, including the traumatic Asian Financial Crisis in 1997–98. Undoubtedly, China will have to go through a similar long-run slowdown and adaptation in the future.

What are the patterns and regularities that govern the slowdown process? Unfortunately, the rule that emerges from the study of these earlier slowdowns is that there is no rule.[9] In terms of its level of income, China is not necessarily at the turning point yet. According to the comprehensive study of Eichengreen, Park, and Shin (2011), it is not until about 2015 that China will reach the average income level at which predecessor economies experienced slowdowns. But of course, even here there is some ambiguity. In the first place, 2015 is not that far away. Moreover, the price conversions on which these income level calculations are based are extremely weak and uncertain. Thus, though comparative studies do not tell us that China is inevitably entering a growth slowdown, neither do they provide much reassurance that China is *not* entering that slowdown. In fact, there are two strong reasons to believe that China is indeed entering a period of long-term growth slowdown, and at this very moment.

## Rapid Change in Labor Supply

The first reason to expect an abrupt slowdown in the long-run rate of Chinese growth is that Chinese labor market conditions are changing extremely rapidly. The changes are complex, because many different things are happening simultaneously. However, all the different changes point in the same direction: China's labor force growth is already slowing very dramatically, and in just a few years the labor force will begin to shrink. Moreover, this transformation of the labor market will occur even more rapidly with respect to the market for relatively unskilled labor. Indeed, it is likely that the supply of unskilled labor has already begun to shrink. The complexity of the changes comes because three different, conceptually distinct, changes in China's labor supply are in fact occurring simultaneously. All of these are predominantly long-run changes, and it is more or less only by accident that each one is occurring rapidly right now. The three changes are an absolute decrease in the number of young people entering the labor force; the exhaustion of the pool of potential young rural-to-urban migrants; and the rapid rise in the number of young potential workers entering the tertiary education system.

First, the decline in the supply of young workers has already begun. According to the 2010 census, there are today 28 million Chinese who were born in 1990. That year was the last peak of births: slightly more Chinese were born in 1990 than in the previous peak "baby boom" years of 1968–70. In the years after 1990, the number of new births declined significantly, before stabilizing somewhat after 1997 at around 13–15 million.[10] The implications of this history for today's labor force are extreme. Those born in 1990 are already in the labor force, or just entering it as they graduate from college. But from now on, the number of young workers entering the overall work force every year will decline, particularly over the next decade. The immediate impact of this change is that overall labor force growth will slow. A further stage will be reached when the number of retirees starts to increase rapidly, several years from now. By 2020, retirees will outnumber new labor market entrants, and the labor force will start to shrink. When this happens, problems of population aging will become serious. But more importantly, right now, the growth rate of the labor force has already dropped sharply.

Second, the number of young rural residents ready to move to non-agricultural jobs in distant locations has been declining in recent years as well. This has led to a vigorous discussion about whether China has now exhausted the pool of "surplus labor" in the countryside. That is, has the supply of underemployed young people, who could move to much higher productivity occupations in the city, been drawn down to nearly nothing? If so, that implies that wages for unskilled workers will begin to increase, as employers are increasingly forced to compete for the available supply of workers.[11] These changes imply that growth will slow down in those industries that traditionally rely heavily on unskilled labor. The number of workers will decline, while their wage will increase, raising costs and decreasing competitiveness of those industries.

Third, the increase in the intake into higher education has been extremely rapid. In 2011, 6.8 million students enrolled in universities, colleges, and vocational schools; 6.1 million graduated.[12] College education defers labor force entry, but also permanently reduces the number of young people who anticipate taking low-skill jobs. In 2011, about 18 million students turned 17, but 6.8 million of these went to college. This is already a remarkably high intake rate for a country at China's income level. Such a high college intake rate means that labor supply trends are very different for college-educated versus less-skilled workers. In 2011, 6.1 million students graduated from college or junior college, which implies that the supply of college-educated workers is growing at more than 10 percent per year. For less-skilled workers, the total addition to potential supply was 11.2 million in 2011 (18 million minus 6.8 million). This is probably less than the total number of workers leaving the work force as they grow older, as the overall working population is only increasing by 3 million per year. The supply of less-skilled workers is in fact already shrinking.

The change in labor force conditions is not a bad thing. Indeed, over the long run it is a good thing for China to have a more highly skilled and slower-growing labor force. However, the speed of these changes will increase the pressure to transform the growth model. Traditional industrial sectors will no longer be able to count on abundant cheap labor, while the economy will be under pressure to provide jobs for the rapidly growing supply of college-educated workers. Already there are numerous anecdotal stories of unemployed college grads, as well as college graduates compelled to take jobs far below their aspirations. The extraordinarily rapid shift in the composition of the labor force puts the Chinese economy under more pressure to adapt rapidly. It also implies that the underlying structural changes that bring the end of the high-growth period are already at play in China. Although China may not have reached the "average" income at which high-growth periods end, it has already begun to experience the demographic and labor force changes that are associated with the transition to slower growth. That leads us to expect an earlier transition to lower growth.

## High Investment and Undervalued Currency

The second reason to expect a shift to a lower growth path in China is that over the past several years, China has maintained an extraordinarily high investment rate. Clearly, a big investment effort can maintain growth over the short term. However, normally we would expect a high investment rate to eventually come back down. But China was already maintaining an extremely high investment rate—over 40 percent for the six years from 2003 through 2008—and then *increased* its investment rate in the face of the global financial crisis. In the three years since (2009 through 2011), China has maintained an average investment rate of 48.5 percent, which has yet to show signs of coming down. This is the highest sustained investment rate for which there is historical evidence in any economy ever. But a high investment effort was also associated with a more abrupt transition to slower growth in the sample studied by Eichengreen, Park, and Shin. (They also found an association between an undervalued exchange rate and the size of the growth slowdown). It is not hard to see the connection: As the underlying conditions in the economy change, pushing it toward a lower growth path, government policy seeks to maintain the higher growth rate by pushing up investment. This can defer the shift to a lower growth path, but when the inevitable shift occurs, it is larger and more abrupt. This description fits China well.

## Which Slowdown Is It?

The immediate causes of China's growth slowdown in 2012 are short-run and monetary, not long-run and structural. The immediate cause of the slowdown is contractionary monetary policy designed to purge the effects of inflationary pressures that have been building since 2009. The current slowdown has been caused by the need to deflate asset "bubbles" in numerous areas of the economy. Thus what we are observing today is not in and of itself the shift to long-run slower growth. But then again, the 1973 oil crisis was not the "cause" of Japan's shift from high-speed to medium-speed growth, nor was the Asian financial crisis of 1997–98 the "cause" of Korea's shift to lower growth. But these external effects happened to coincide with, and perhaps trigger, changes that were already in prospect over the longer term. The result was that those changes occurred with surprising speed and unusual force. Is there any reason to think that China will be different?

## Facing the Challenge of Lower Growth

The challenges and uncertainties discussed above have produced a widespread sense among government leaders and ordinary people in China that a growth slowdown is under way. How severe it will be, and how long it will last, is difficult for anyone to determine. Even the large central state-owned enterprises have been strongly urged by their supervisors to prepare for a long winter.[13] Obviously this contributes to the leadership and policy uncertainty that Chinese leaders already feel. China's leaders are aware that they need to maintain flexibility to deal with coming challenges: It would be unwise to commit too strongly, in advance, to a certain set of policy prescriptions. This caution in turn contributes to the relative lack of policy guidance in the months leading up to the leadership transition. The smugness that surrounded China's rapid emergence from the global financial crisis in 2009 to 2010 has now evaporated.

This unprecedented set of economic circumstances is creating unexpected shifts in policy and political alignments. In the next issue of *China Leadership Monitor*, I will describe some of these effects. The new challenges have created a greater demand for economic expertise, and opened up opportunities for economic reformers. They have led to increasing criticisms of the outgoing leaders, whose policies are seen to have contributed to the dilemmas and challenges that increasingly stare China in the face. The same challenges have raised pressure on the incoming leaders, and led them to look for ways to break with business as usual.

## Notes

[1] See Barry Naughton, "Macroeconomic Policy to the Forefront: The Changing of the Guard," *China Leadership Monitor*, no. 36, Winter 2012.

[2] All official data are quoted from the National Bureau of Statistics website, accessed through http://www.stats.gov.cn/.

[3] National Bureau of Statistics, "2012年4月份规模以上工业生产运行情况" (Production and operation conditions of above-scale industry in April 2012), May 12, 2012, accessed at http://www.stats.gov.cn/was40/gjtjj_nodate_detail.jsp?channelid=75004&record=56.
[4] Ma Xiaoming (马晓明), "房地产市场调控仍处在关键时期" (Recontrol of the Housing Market is Still in a Crucial Period ), July 18, 2012, accessed at http://www.stats.gov.cn/tjfx/jdfx/t20120718_402819253.htm.
[5] Zhang Yuzhe, "Platform Companies Make a Comeback," *Caixin Online*, July 18, 2012. Accessed at http://english.caixin.com/2012-07-18/100412475.html.
[6] Huo Kan and Yu Hairong, "Tailoring Policy for Slowing Economic Growth," *Caixin Online*, July 13, 2012, accessed at http://english.caixin.com/2012-07-13/100410897.html; Simon Rabinovitch, "Optimists pierce gloom on China's growth," *Financial Times* (London), July 13, 2012, p. 4.
[7] Zhou Wentian (周文天), "一个县的保八战：现在已没有土地可开发 考核只能造假" (A county's battle to 'maintain 8' [percent growth]: Now there's no more land to develop, so they have to make it up), 中国证券报 (China Securities Journal), June 7, 2012, accessed at http://finance.ifeng.com/news/region/20120607/6572603.shtml.
[8] National Bureau of Statistics, "2012年6月份全国规模以上工业生产运行情况" (Production and operation conditions of above-scale industry in June 2012), July 13, 2012, accessed at http://www.stats.gov.cn/tjfx/jdfx/t20120713_402817911.htm.
[9] For an extremely accessible version of the results of the most important recent study, see Barry Eichengreen, "Escaping the Middle Income Trap," Federal Reserve Bank of Kansas City, *2011 Economic Policy Symposium*, August 25–27, 2011, accessed at http://www.kc.frb.org/publicat/sympos/2011/2011.Eichengreen.Remarks.pdf. For the full study on which the remarks are based, see Barry Eichengreen, Donghyun Park, and Kwanho Shin (2011), "When Fast Growing Economies Slow Down: International Evidence and Implications for China," *NBER Working Paper* no.16919 (March).
[10] The drop may be overreported if there is undercounting of "hidden children" due to evasion of strict birth control laws. While this can be an important effect, it could not be large enough to eliminate the trends being described here. *China 2010 Census, Summary Volume*, Table 3-1, Population by Age and Gender (Beijing: National Bureau of Statistics, 2012).
[11] There is a rich developing literature in China (and outside as well) over this issue, and whether China has reached the "Lewis turning point" when the supply of unskilled labor is no longer highly elastic, and wages start to rise sharply. For a good collection of academic articles on the subject, see the 2011 special issue of *China Economic Review,* and especially the article by the leading proponents of this view, Cai Fang and Du Yang, "Wage increases, wage convergence, and the Lewis turning point in China," *China Economic Review*, 21: 601–610.
[12] 中国统计摘要 (China Statistical Abstract）2012, pp. 165–66; 44–45.
[13] 央企当如何维稳中国经济 (How can central SOEs contribute to stabilizing China's economy?), 经济观察报-社论 (Economic Observer: front-page editorial), July 2, 2012, p. 1.