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Conquering China's Unbalanced and Inadequate Development: Macroeconomic Outlook, Policy Simulations, and Reform Implementation—A Summary of Annual SUFE Macroeconomic Report (2017–2018)¹

Abstract Leaving year 2017 China's macroeconomy is continuously characterized by unbalanced and inadequate development. Whereas some aggregate indicators have shown improvement over the year, the cumulative growth rates in consumption and fixed asset investment have continued their

¹ This article summarizes the main findings from a similarly titled annual report (2017–2018) released in December 2017 by China Macroeconomic Analysis and Forecast Team at Institute for Advanced Research (IAR) in Shanghai University of Finance and Economics (SUFE). Established in 2009, the research team has developed a quantitatively oriented, semi-structural framework (IAR-CMM) that combines unique Chinese characteristics with general international experiences to unify the analyses of prominent short-, medium-, and long-term issues facing the transitional Chinese economy in an internally coherent manner. Reports on the most critical results emanated from the analyses have been released on quarterly, semiannual, and annual basis and have attracted increasing attention from the private sector, policymaker, popular press and general public. Other members of this research team include (in alphabetical order of last names) Xudong Chen, Yuanyuan Chen, Jian Gong, Qian Li, Run Liang, Liguang Lin, Keqin Liu, Zixi Liu, Songcheng Sheng, Rongsheng Tang, Xiaowen Wang, Yuqin Wang, Howei Wu, Huabin Wu, Yibo Yang, Tongbin Zhang, Lin Zhao, and Mei Zhu.

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downward trajectories. Worsening income inequality and resource misallocations, both between secondary and tertiary industries, and within the latter, pose serious challenges, let alone the systemic risk associated with the flourishing shadow banking system, rapid credit growth and debt overhang that weigh on the Chinese economy like the Sword of Damocles. This summary report highlights both the status quo and the consequences of the unbalanced and inadequate development embodied in China's persistently distorted economic structure, and the role of deepening reforms of the institutions and governance in resolving the problems. Our analyses based on IAR-CMM model provide a unified framework for addressing China's short-, medium-, and long-term issues in an internally coherent manner. Looking into year 2018, our benchmark projection of real GDP growth rate is 6.7% (6.41% using more reliable rather than the official data). Alternative scenario analyses and policy simulations are conducted to reflect various aspects of the economic challenges in the short to long runs. Through the lens of these analyses we conclude that rule-of-law based and market-oriented structural reforms should continue to hold a center stage in China's transition from a phase of high-speed but unbalanced growth, to a stage of balanced and adequate high-quality development.

Keywords unbalanced and inadequate development, macroeconomic outlook, alternative scenario, policy simulation, systemic risk, reform

JEL Classification E01, E17, E27, E37, E47

Leaving year 2017 unbalanced and inadequate development continues to characterize China's macroeconomic landscape. While some aggregate economic indicators have shown improvement over the year, growth in consumption and fixed asset investment has slipped further. The weaker consumption growth is largely attributed to the rapid accumulation of household debt and resurgence in income inequality, which also are factors dragging consumption upgrade. The weaker investment growth, on the other hand, does not appear to be the result of any well-conceived or well-designed process of restructuring, from an investment-driven toward a consumption\services-led model of growth and development, with economic efficiency or welfare in mind. Rather, it manifests the procrastination in China's transformation into a market economy, which elongates a distorted financial and economic structure with overpowered government in the allocation of resources. The resultant resource misallocations,

especially those between the secondary and the tertiary industries, as well as those within the latter, which are exacerbated by the investment directives of state-owned capital, are among major challenges to the Chinese economy. Looking into year 2018, weak consumption and investment growth may continue to exert downward pressures on China's GDP.

A more conspicuous challenge takes root in the impeding systemic risk associated with the flourishing shadow banking system, rapid credit growth and debt overhang that weigh on China's economy like the Sword of Damocles. Of particular attention is the aforementioned rapid growth in household debt, which together with the corporate and local government debt overhang poses a clear and present threat to the soundness of the nation's financial system. Prevention of the systemic risk should be a primary mission of monetary and macro-prudential policies in year 2018.

We have obtained the above assessments using IAR-CMM model developed by Institute for Advanced Research at Shanghai University of Finance and Economics, taking both cyclical and secular factors into consideration. Thus our analyses provide a unified framework for addressing China's short-, medium-, and long-term issues in an internally coherent manner. According to our baseline forecast, the recent upward tick in real GDP growth is unlikely to continue in year 2018, but instead, growth will retreat to a lower rate of 6.7%, or 6.41%, based on more reliable rather than the official data. Alternative scenarios analyses concerning various internal and external risks and uncertainties lend support to the robustness of our main conclusions.

In addition to providing the forecasts with the baseline and alternative scenarios, we have also conducted policy simulations under various scenarios to configure a menu of policy options that may help achieve growth needed to ensure social stability. Whereby these analyses reflect different aspects of economic and political challenges faced by the Chinese government in the short to long runs, we stress that these kinds of policy packages should be used with caution in light of their side effects, especially from a long-term perspective.

We have called attention to the fast growing household debt since our last year's annual report, because our analyses show that this has become a greater issue but it has been largely overlooked or understated until recently. Based on a nationally representative household survey, we find that the percentage of liquidity constrained households has increased dramatically with the accumulation of household debt and the tightening in the liquidity constraint has

crowded out much of household consumption expenditure. This finding is reinforced by our analysis based on provincial-level panel data, which shows that the dramatic increase in household indebtedness has led to a significant reduction in the growth rates of household consumption expenditure and GDP. In this annual report we are also calling attention to the widening economic inequality that, according to our analyses based on similar and related datasets, not only has led to reduction in consumption and GDP growth but also puts social stability at risk.

Given the decisive role of deepening reforms of the institutions and governance in the conquest of the unbalanced and inadequate development embedded in China's persistently distorted financial and economic structure, we have furthered the resource misallocation\growth accounting analyses reported in our previous year's annual report. We find that distortions between agricultural and non-agricultural sectors and between state and non-state sectors have both worsened, contributing to the recent decline in the growth rate of aggregate total factor productivity (TFP). Distortions and resource misallocations between secondary and tertiary sectors and within the latter are even more severe, due in large part to procrastination of service sector SOE reform, which has led to dramatic efficiency losses that are responsible for the recent decline in service sector TFP. The problem is exacerbated by the investment directives of state-owned capital in the service sector. We find that the decline in the service sector TFP is a main driver of the recent decline in the aggregate TFP growth rate.

Through the lens of these analyses we conclude, as we have long advocated, that rule-of-law based and market-oriented structural reforms, with well-designed and well-conceived strategies that properly weigh short-, medium-, and long-term matters, should continue to hold a center stage in China's transformation into a new era that prioritizes quality over speed for economic growth to ultimately achieve balanced and adequate development.

1 Macroeconomic Outlook

1.1 Continuous Decline in Consumption Growth with Lackadaisical Demand

Cumulative growth in total retail sales of social consumer goods in 2017 continued the falling trend that started in 2009 (see Figure 1), even though

certain category of luxury consumption goods, such as cosmetics, showed weak signs of upgrade. The year-over-year real growth rate had been lower than 10% all year round and declined to 9.1% at the end of 2017, 0.5 percentage points lower than in 2016. As a contrast to the strong growth in housing-related consumption in year 2016, there is a sharp drop in the growth rate of housing-related expenditures in year 2017, due to the slump in real estate induced by the tightening of regulations in the housing market. Declining growth in household disposable income, rising economic inequality, and tightening liquidity constraint in the face of household debt overhang are also among the main factors behind the weaker consumption growth. On the other hand, overseas shopping has continued draining resources from demand for domestically produced goods and services, whereas from a longer-term perspective some fundamental imperfections of the nation's social-economic system, such as lack of public services, social security, and social safety net have remained the main draggers of consumption growth and upgrade. All of these make consumption unlikely a major source of economic growth in the near to medium terms, not until some "People First" policies are implemented to improve household liquidity and reduce the incentives for precautionary saving.

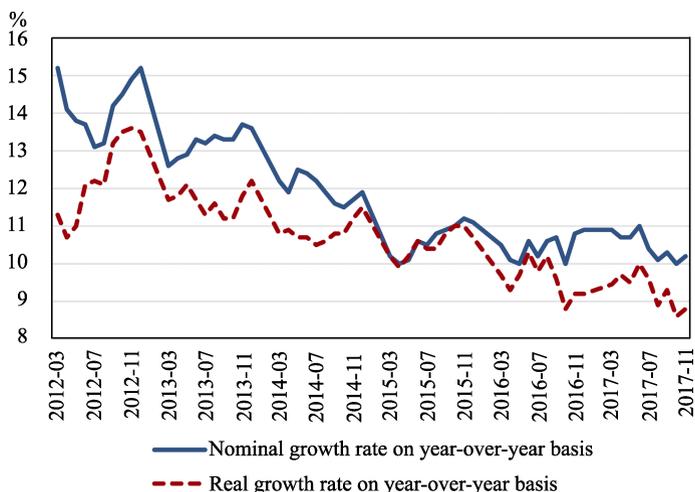


Figure 1 Growth of Total Retail Sales of Social Consumer Goods

Source: National Bureau of Statistics of China.

1.2 Lackadaisical Investment Growth in the Face of Profitability Divergence between Upstream and Downstream Manufacturing Firms

Cumulative growth of real investment in 2017 has continued its downward trend that started in 2013 with sectorial growth rates showing drastic divergence (see Figure 2). The de-stocking of housing inventory led to a decline in the inventory-to-sales ratio that boosted investment in real estate development, but overall growth in housing market investment declined further due to the tightening of regulations. Growth in infrastructure investment (especially private investment) also edged down in 2017 amid the risk exposure of public-private partnership (PPP) projects, and this downward pressure is likely to persist in 2018. Profits rose sharply in the manufacturing industry, but mainly for upstream firms, driven by the continuous rebound in the Producer Price Index (PPI) that started in 2016. The highly concentrated upstream sector is dominated by monopolistic state-owned enterprises (SOEs), as opposed to the more liberalized downstream sector that is composed mostly of competitive non-SOEs. The profitability divergence between the upstream and downstream sectors due to ownership discrimination and monopolistic distortions reflects in part the unbalance development within the manufacturing industry. This together with the upward cost pressures generated by the environmental curbs reduced the growth rate of manufacturing investment in year 2017 to 4.8%. Deepening SOE reforms

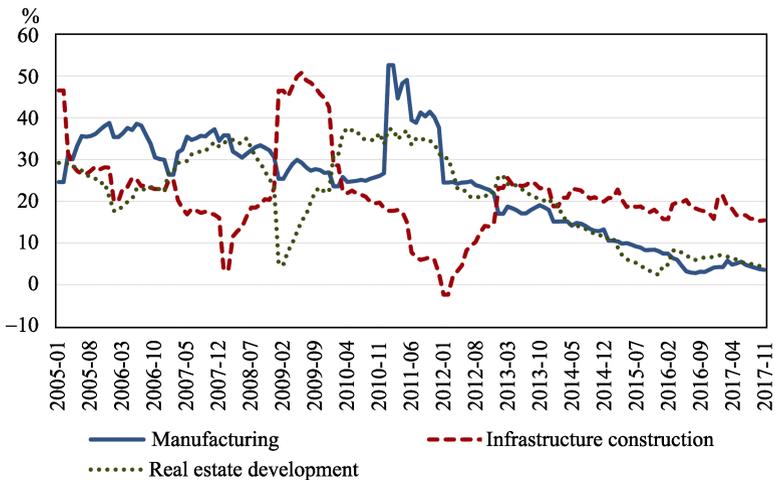


Figure 2 Cumulative Growth Rates of Fixed Asset Investment in Three Major Categories

Source: CEIC, IAR SUFE.

to remove institutional barriers and introduce competitive mechanisms is the key to remedying resource misallocations within the manufacturing industry.

1.3 Rebounding Import and Export with Declining Trade Balance

The long-awaited recovery in China's exports and imports continued throughout 2017 with imports growing faster than exports (see Figure 3). Aside from a base effect, growth in exports was largely boosted by global economic recovery. However, looking into 2018, although the US tax reform is likely to be a beneficiary factor for China's exports, recovery of the manufacturing sector in the US and Europe may tend to reduce China's exports of terminal products and hinder its industrial manufacturing, whereas concerns over a potentially disastrous trade war between the US and China pose additional uncertainty about the sustainability of China's exports rebound. On the other side, while the recovery of China's imports growth was more significant, owing much to the continued rebound in bulk commodities prices and shortage of high-quality domestic goods and services, year 2017 saw further widening in service trade deficit (due mainly to strong growth in tourism service imports) amounting to USD2.1659 trillion, 212.3 billion above that of 2016. The widening gap between merchandise and service trade balances highlights a growing conflict between the

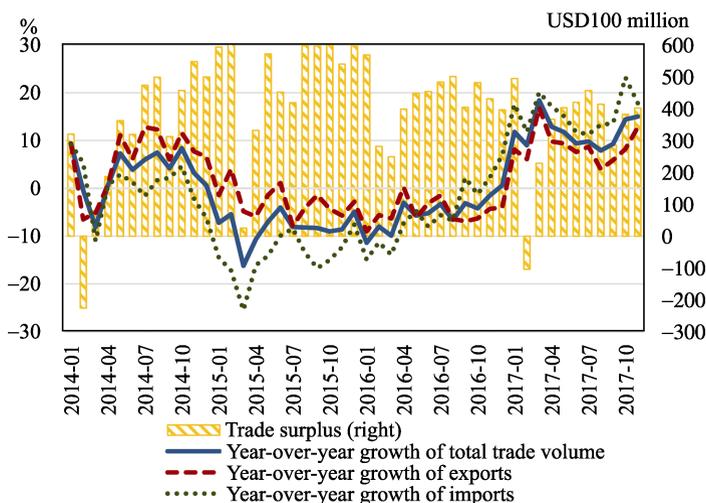


Figure 3 Major Indicators of Trade (in USD)

Source: China's General Administration of Customs.

desire for consumption upgrade in order to meet the people's ever-growing needs for a better life and the unbalanced and inadequate development in the manufacturing and service industries. This presents both challenges and opportunities. A key to meeting the challenges and exploiting the opportunities lies with deepening reforms, especially in the service industry, which should facilitate consumption upgrading and promote new engines of growth and development.

1.4 Stable RMB Exchange Rate and Foreign Exchange Reserves

The year of 2017 saw faded fear for RMB depreciation and tightened capital control. As a result, the risk of capital outflows receded and the foreign exchange reserves rose above USD3 trillion again. The Chinese yuan reversed its course of depreciation sustained over the three preceding years (see Figure 4), as the People's Bank of China (PBOC) had improved its ability in managing the RMB exchange rate and enhanced the effectiveness in communicating with the market, but also thanks to its ample foreign exchange reserves and more flexible monetary policy tools like the “counter-cyclical adjustment factor” introduced in May 2017 as a means to offset market sentiment. The switch in the priority of the PBOC, from the internationalization of RMB in 2016, to the stabilization of the RMB exchange rate in 2017, was both timely and effective. Looking into year 2018, a major task of the PBOC is to deal with the spillover effects of global monetary policy tightening to help prevent systemic financial risks while at the same time maintain its monetary policy autonomy.

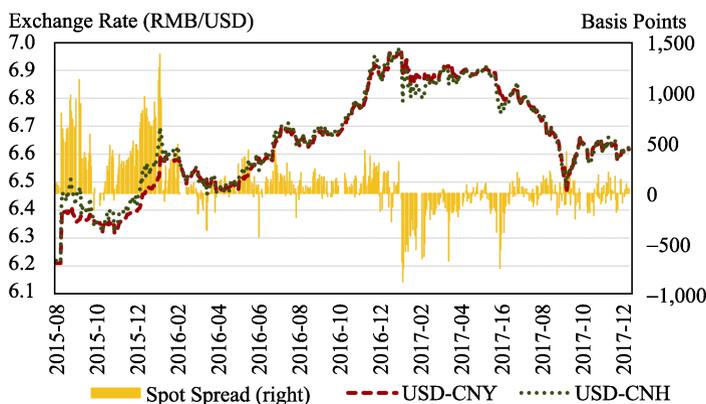


Figure 4 Onshore RMB Market (CNY) and Offshore RMB Market (CNH)

Source: Wind.

1.5 Rising PPI but Stable CPI

The year-over-year CPI growth remained below 2% over year 2017 due mainly to the sluggish demand, and the core CPI, excluding food and energy, grew at a rate of 2.2% on year-over-year basis (see Figure 5). Given that food and service prices take up 20% and 35% of CPI, respectively, the shortage of low-skilled labor in big cities resultant from the recent population control policy and the rising demand for health care are likely to exert upward pressures on CPI in year 2018. Meanwhile, led by the increase in raw material prices, PPI had risen sharply since 2016 and remained at a high level during 2017 due in large part to the supply-side structural reforms. GDP deflator followed the footsteps of PPI and also accelerated, growing at the rate of 4.61%, 3.93%, 4.09% and 3.96% on year-over-year basis for each of the four quarters in 2017, with cumulative annual growth of 3.98% by year end. The divergence between CPI and PPI is yet another manifestation of the unbalanced development in the manufacturing industry where the recent increase in profits mostly went to the upstream SOE firms as a result of their monopoly power but not for reason of productivity. Looking forward into the short to medium terms, while the pass-through from PPI to CPI is still unclear given the lackadaisical demand from households and the competition among downstream firms, the deflation scare discussed in our previous annual and quarterly reports has largely receded.

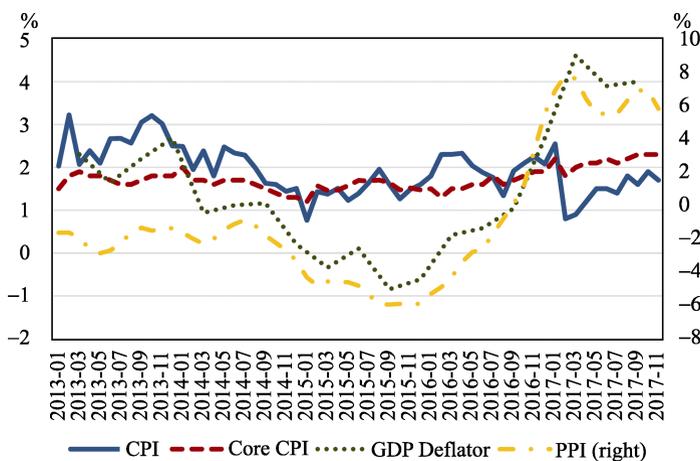


Figure 5 Price Change

Source: National Bureau of Statistics of China, IAR SUFE.

1.6 Divergence between Money Supply and Total Social Financing with Increased Financing Costs

There was a big divergence between money supply and total social financing in 2017. Specifically, the year of 2017 witnessed an 8.2% increase in yearly growth rate of the M2 measure of money supply (amounting to RMB167.7 trillion), but a 12% increase in yearly growth rate of total social financing (amounting to RMB174.6 trillion), which is 3.8 percentage points higher than the former. This gap is in part a result of financial deleveraging. While this in principle might suggest a more effective money creation process and more efficient use of funds, it also brought with it some side effects, such as higher costs of capital. Indeed, as a result of tightened liquidity that accompanied financial deleveraging financing costs rose, especially for micro, small and medium firms, exerting some adverse effect on real economic activity. By the end of Q3 2017, the weighted average interest rate of all loans was 5.8%, a 0.6 percentage point increase on year-over-year basis. Among all these loans, the weighted average interest rates of ordinary loans, mortgage loans, and negotiable instruments were 5.9%, 5.0% and 4.98%, respectively (see Figure 6). The increased interest burden could raise the ratio of nonperforming loans (NPL) and the risk of default, and expose the banking system to greater systemic risks. In order to offset such adverse effect, the Chinese government should unswervingly manage the deleveraging process, make the financial system more adaptable and open, and orderly promote direct finance.

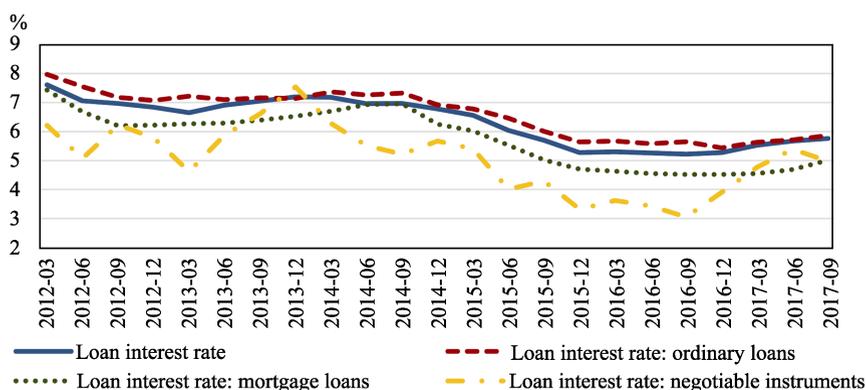


Figure 6 Weighted-Average Interest Rates on Loans

Source: People's Bank of China.

1.7 Growing Local Government Debt Rollover Payment Pressure

With an estimated debt-to-GDP ratio of about 21.3%, the overall debt load of local government increased slightly in 2017, but remained below the local government debt ceilings, amounting to RMB16.9 trillion. The pressure on the replacement of local government debt has largely receded with the implementation of the debt-for-bond swap program introduced in 2015. While the debt-for-bond swap program delays the repayment and reduces the present credit risk, it does not eliminate the debt and may even put more rollover repayment pressure on local governments in the coming years. Meanwhile, the aforementioned interest rate increment (see Figure 7), reinforced with banks' declining enthusiasm to invest in municipal bonds, also raised the costs of newly issued municipal bonds, exerting repayment pressures in the future, especially for some local governments with sparse financial resources. According to our analyses of the disclosure documents from local governments issuing municipal bonds, many provinces that have promised debt repayments in the future reply on revenues from transferring state-owned land-use rights. Hence, in addition to the interest rate risk discussed above, the problem of land finance constitutes an additional source of risk associated with local government debt. The regional imbalances could exacerbate resource misallocation and deter economic restructuring especially in underdeveloped regions whose fiscal revenues rely too much on land sales. To deal with this problem, deepening land reform and

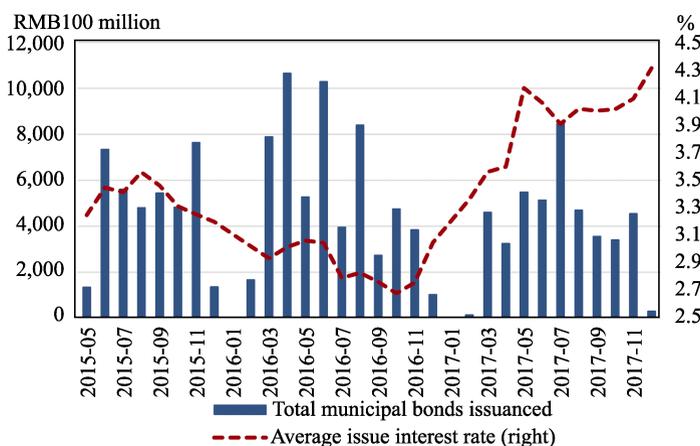


Figure 7 Issuance Scale and Interest Rate of Local Government Bonds

Source: Wind, IAR SUFE.

orderly implementing a property tax system should be elevated to the top of the government's agenda.

1.8 Accumulating Household Debt with Regional and Structural Heterogeneity

The rapid growth of household debt has received increasing attention, even though its level is still below corporate and government debts. The fast growing household debt already had adverse effects on household liquidity and consumption, as well as GDP. Using household level data from China Family Panel Studies (CFPS), we find that the percentage of hand-to-mouth (HtM) households increased from 22% in year 2010 to 45% in year 2014. The tightened liquidity constraint reduced consumption growth, posing long-term risk on economic development. As we will discuss in more detail in Part 2 below, a one percentage point increase in the household debt-to-GDP ratio is associated with a 0.3 percentage point decrease in GDP growth rate. Although the housing market regulations were tightened in 2017, the growth rate of household debt remained above that of 2015 and before, and was only slightly slower than that of 2016 (see Figure 8). By Q2 2017, household debt had already reached 46.8 percent of GDP, amounting to RMB37 trillion. Over this course of household debt accumulation, the leverage ratio, defined as the household debt-deposit ratio, had exceeded 50% in 15 provinces, among 9 of which the ratio had exceeded the

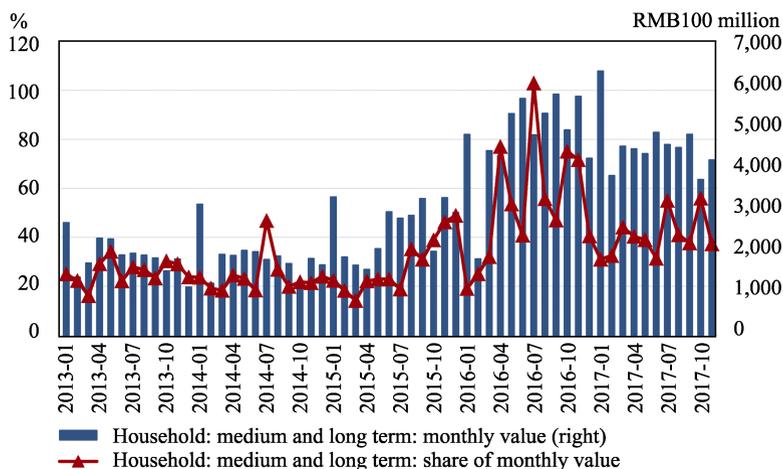


Figure 8 Growth Rates of New RMB Loans

Source: IAR SUFE.

national average of 62%, revealing a great amount of regional and structural heterogeneity. It is worth special attention that some of the heavily indebted provinces are also less developed regions and this imbalance could expose these areas to great systemic risk. On the other side of maturity structure, short-term loans also increased sharply in 2017. By year end, newly issued short-term household loans amounted to RMB1.8 trillion yuan, a 1.2 trillion increase from the level in 2016. The ballooning short-term loans impose immediate stress on household liquidity and constraint on monetary policy.

1.9 Increasing Income Inequality

Income inequality started rising again in 2016, after six years of declining, and deteriorated further in 2017, reflecting the fundamental problems of unbalanced and inadequate development in China's economy. We highlight the impact of increasing income inequality in three aspects. First, increase in income inequality crowds out aggregate household consumption due to the heterogeneity of the marginal propensity to consume (MPC). Using household survey data from CFPS we have constructed provincial-level income inequality indexes. Our analyses based on these indexes show that when Gini coefficient increases by 0.01 units, consumption growth decreases by 0.4% to 0.5% (see Figure 9). The results are estimated with province and year fixed effects. In addition, rising income inequality slows down the process of consumption upgrading, measured by the increase in spending on education, recreation and medical care as a fraction of total consumption expenditure. Second, rising income inequality reduces social stability, raises uncertainty, and lowers the willingness of enterprises to invest. Third, reduction in aggregate demand slows down economic growth. Our estimates show that a 0.1 unit increase in Gini coefficient leads to a 0.13% decline in GDP growth. Furthermore, the impact of changes in income inequality is asymmetric. Specifically, the positive effect on growth of lowering income inequality is greater than the negative effect of rising income inequality. Because China's Gini coefficient has been above the international alert line for a long time, reducing income inequality can have a significantly positive effect on long-run growth and development.

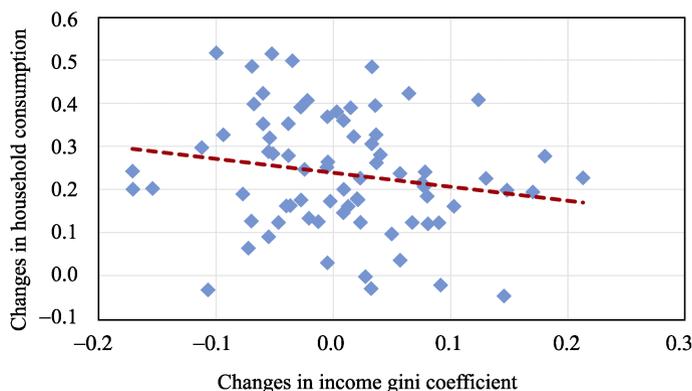


Figure 9 Relationships between Changes in Income Inequality and Household Consumption
Source: CFPS, IAR SUFE.

1.10 Systemic Risks and Systemically Important Financial Institutions

Preventing systemic risks is the primary mission of monetary and macro-prudential policies in year 2018. In light of this mission, it is fitting that some exploration is undertaken to study the stability property of China's financial system and to identify systemically important financial institutions. We have carried out the analyses using a CoVaR model and a network model. According to our CoVaR analysis based on daily data of 16 listed commercial banks for the period 2009–2017, the big four state-owned banks have remained systemically most important banks, but their roles in preventing systemic risks have somewhat declined and their risk spillover effects have increased. Thus the conclusion from our previous reports continues to hold in that the key to maintaining the stability of China's banking system is to ensure the soundness of the big four state-owned banks, although the role played several other banks also deserves attention. Our network analysis covering a broader range of financial institutions has reached a similar conclusion that it is systemic risks rather than the risks of individual institutions that pose the greatest threat to China's financial system.

2 Near to Medium Term Forecasts and Policy Simulations

Our semi-structural forecasts, alternative scenarios analyses, and policy simulations are based on quarterly IAR-CMM model. Table 1 displays baseline

growth projections for major macroeconomic indicators for each quarter of 2018, along with the realizations of these variables in the four quarters of 2017.² Four major assumptions about external environment underlying the baseline forecast are summarized below.

(1) Global recovery assumptions for major developed economies are taken from IMF October 2017. Rates of economic growth in 2018 are projected to be 2.0% for the US, 2.3% for the Eurozone, and 0.7% for Japan;

(2) Prices of certain international bulk commodities are expected to rebound gradually and crude oil prices fluctuate within a narrow range;

(3) Three 25 base point federal funds rate hikes in 2018;

(4) The withdrawal of foreign direct investment (FDI) induced by the negative spillover effects of the US tax reform in the next few years.

Table 1 Near to Medium Term Baseline Forecast of Yearly Growth Rate

	2017 Q1	2017 Q2	2017 Q3	2017 Q4	2017	2018 Q1	2018 Q2	2018 Q3	2018 Q4	2018
GDP	6.9	6.9	6.8	6.8	6.9	6.7	6.6	6.6	6.7	6.7
GDP(adjusted)	6.61	6.61	6.5	6.4	6.5	6.4	6.3	6.3	6.4	6.4
Consumption	10.9	11.0	10.3	9.9	10.2	10.6	10.3	10.1	10.7	10.4
Investment	9.2	8.6	7.5	7.0	7.2	6.9	7.0	7.1	7.1	7.1
Export ³	8.1	9.4	6.9	9.7	7.9	12.2	7.6	9.1	6.9	8.8
Import	24.1	14.7	14.5	12.5	15.9	14.3	15.6	8.9	5.3	10.7
CPI	1.4	1.4	1.6	1.8	1.6	1.8	2.3	2.1	2.2	2.1
PPI	7.4	5.8	6.2	5.9	6.3	3.6	4.2	3.5	1.8	3.3
GDP Deflator	4.6	3.9	4.0	4.0	4.0	2.4	2.9	2.3	1.9	2.4

Source: IAR, SUFE.

There are also seven baseline assumptions concerning internal environment.

(1) Lackluster consumption demand in the face of gradually upgrading consumption structure through the end of 2018;

² The projections reported here were obtained at the end of 2017.

³ The import and export statistics here are all measured in USD and are comparable to those reported by the customs.

- (2) Foreign trade continues to rise;
- (3) Growth rates of 5.5%, 13%, and 4% for investment in manufacturing, infrastructure, and real estate, respectively, in 2018;
- (4) Heightened systemic risks in the banking system with commercial banks' NPL ratio reaching 1.74% by the end of 2018;
- (5) Steady accumulation of household debt with the household debt-to-GDP ratio increasing by 1.2 percentage points per year;
- (6) Fiscal policy is expected to remain stimulative, with the deficit rate kept at 3%, and the government budget deficits growing to RMB2.6 trillion by the end of 2018;
- (7) Monetary policy, subject to internal financial regulation and external tighter global monetary policy, is most likely to remain prudent and tight in year 2018, but the goal of maintaining economic growth limits the tightening of monetary policy. Hence, we expect one 25 base point hike in the benchmark interest rate.

The take-home message from the baseline forecast, as can be seen from the first two rows of Table 1, is that economic recovery is unlikely to continue in the near to medium term, with annual real GDP growth rate declining to 6.7% (6.41% using more reliable instead of official data) in 2018.

In light of the various aspects of unbalanced and inadequate development outlined in the economic outlook, we have considered alternative scenarios to explore the implications for the outlook of alternative forecast assumptions. Specifically, we have studied six alternative scenarios to accommodate for the various aforementioned internal and external economic factors. Dividing them into three groups, with each highlighting a particular risk or uncertainty factor, we report below the major assumptions and results for each of the alternative scenarios.

Among the three groups, we first highlight the macroeconomic effect of China's soaring household debt. According to the Bank for International Settlements (BIS) data, the household debt-to-GDP ratio increased to 46.8% in the second quarter of 2017, and the growth rate is so high, even higher than that in the US over an equal length of period preceding the recent global financial crisis. Theoretically, the effect of household debt overhang on economic growth can be ambiguous. On the one hand, absent a strong wealth effect due to underdeveloped home-equity based borrowing, greater household indebtedness

may lead to slower growth in household consumption and GDP with more stringent liquidity constraint. On the other hand, a mortgage boom may boost real estate investment whereas the stimulated property sales may spur demand for housing-related consumption and thus growth in GDP may go up. Empirically, using the provincial-level panel data for the period 2013–2016, we have found that the negative effect dominates the positive effect. Specifically, we find a negative correlation of -0.3 between household debt-to-GDP ratio and real GDP growth rate (see Figure 10). This is in line with much of the international experience. In other words, a one percentage point increase in the household debt-to-GDP ratio is associated with a 0.3 percentage point decrease in GDP growth rate.

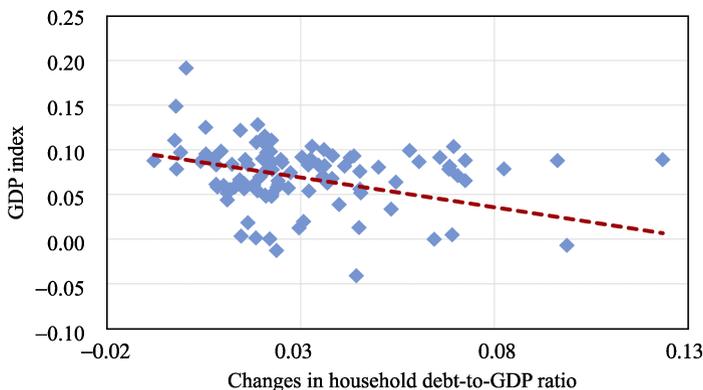


Figure 10 Relationships Between Household Debt and Economic Growth

Source: CFPS, IAR SUFE

Therefore, the first group includes two scenarios with relatively more pessimistic outlooks due to the macroeconomic effect of soaring household debt, which are labeled as Conservatively Pessimistic Scenario 1 and Pessimistic Scenario 1, respectively. In Conservatively Pessimistic Scenario 1, the household debt-to-GDP ratio is assumed to be 2.5 percentage points higher each year, resulting in a reduced annual real GDP growth rate of 5.75% (5.42% using more reliable instead of official data) in 2018. In Pessimistic Scenario 1, the household debt-to-GDP ratio is assumed to be 4.3 percentage points higher each year, resulting in a reduced annual real GDP growth rate of 5.15% (4.78% using more reliable instead of official data) in 2018.

The second group includes two scenarios with other relatively more pessimistic outlooks due to the international spillover effects of the US tax reform, which are labeled as Conservatively Pessimistic Scenario 2 and Pessimistic Scenario 2, respectively. In Conservatively Pessimistic Scenario 2, the growth rate of total investment is assumed to decrease by 0.8 percentage points due to the withdrawal of FDI, resulting in a reduced annual real GDP growth rate of 6.25% (5.94% using more reliable instead of official data) in 2018. In Pessimistic Scenario 2, the growth rate of total investment is assumed to decrease by 1.6 percentage points due to the FDI withdrawal, resulting in a reduced annual real GDP growth rate of 5.85% (5.52% using more reliable instead of official data) in 2018.

Besides the aforementioned relatively more pessimistic outlooks, we consider in the third group two other scenarios with relatively more optimistic outlooks due to better-than-expected performance in China's exports, which are labeled respectively as Conservatively Optimistic Scenario and Optimistic Scenario. In the Conservatively Optimistic Scenario, the growth rate of exports is assumed to increase by 0.8 percentage points, which leads to a 0.2 percentage point increase in the growth rate of manufacturing investment. Annual real GDP growth rate in this scenario is 6.75% (6.45% using more reliable instead of official data) in 2018. In Optimistic Scenario, the growth rate of exports is assumed to increase by 2.7 percentage points, which leads to a 0.6 percentage point increase in the growth rate of manufacturing investment. Annual real GDP growth rate in this scenario is 6.85% (6.56% using more reliable instead of official data) in 2018.

In addition to providing the baseline and alternative forecasts, and given that some minimal growth in year 2018 would be needed in order to ensure social stability, it is also fitting that some explorations are undertaken to configure a menu of monetary and fiscal policy options that may help to achieve that minimal growth. Consider a minimal growth rate of 6.5%, or 6.2% in terms of adjusted data, for year 2018. We do not discuss the baseline scenario and the two scenarios with relatively more optimistic outlooks, because in those scenarios the minimal growth would already be achieved or even exceeded without additional policy stimulus. On the other hand, the situations in Pessimistic Scenarios 1 and 2 are so severe and the side effects of short-term stabilizing tools are so high, that sensible policies would be deepening structural reforms to target on the engrained fundamental and institutional issues. Therefore, we restrict our

discussion to Conservatively Pessimistic Scenarios 1 and 2. Table 2 summarizes the combinations of monetary and fiscal policy options that may help to achieve the minimal growth in year 2018 in these scenarios, with the baseline scenario displayed as a reference point.

Table 2 Alternative Forecasts and Policy Simulations (for year 2018)

	Baseline	Conservatively Pessimistic 1	Conservatively Pessimistic 2
Yearly growth rate	6.7%	5.75%	6.25%
Yearly growth rate (adjusted)	6.4%	5.42%	5.94%
Imputed growth rate	6.5%	6.5%	6.5%
Imputed growth rate (adjusted)	6.2%	6.2%	6.2%
Monetary policy easing	-	50 BP reduction in RRR	25 BP reduction in RRR
Fiscal deficit expansion (billion yuan)	0	400	133
Fiscal deficit expansion rate	0	15.38%	5.13%
Deficit ratio	3%	3.54%	3.23%

Source: IAR, SUFE.

(1) Under Conservatively Pessimistic Scenario 1: A 50 basis point reduction in the required reserve ratio (RRR), and a RMB400 billion increase in fiscal deficit, a 15.38% increase from the 2018 budget.

(2) Under Conservatively Pessimistic Scenario 2: A 25 basis point reduction in the required reserve ratio, and a RMB133 billion increase in fiscal deficit, a 5.18% increase from the 2018 budget.

However, our alternative scenario analyses and policy simulations should not be viewed as suggesting or recommending certain monetary and fiscal stimulus for the government to meet the assumed minimal growth. Rather, we urge that this kind of stimulus packages should be used with caution in light of their side effects, especially from a long-run perspective.

3 Deciphering China's Economic Slowdown from Longer Term Perspectives

While China's medium-term development faces challenges from systemic financial risk, rising income inequality and debt overhang, the key culprit behind

the persistent growth slowdown in recent years, as we demonstrated in Annual Report 2016–2017, lies with the declining growth of total factor productivity (TFP) brought about by institutional barriers and distortions deep-rooted in China’s economic structure. In particular, given that China is striving for a new consumption- and services-led model of growth and development, and the service sector has already made up over 50% of GDP while the share is still rising, the importance of service sector cannot be ignored. It is thus fitting to further the resource misallocation\growth accounting exercises reported in our last year’s annual report to include a service sector analysis. As we will discuss below, distortions between agricultural and non-agricultural sectors and between state and non-state sectors have both worsened, contributing to the recent decline in the growth rate of aggregate TFP. Distortions and resource misallocations between secondary and tertiary sectors and within the service sector are even more severe, due in large part to procrastination of service sector SOE reform, which has led to dramatic efficiency losses that are responsible for the recent decline in service sector TFP. The problem is exacerbated by the investment directives of state-owned capital in the service sector. We find that the decline in the service sector TFP is indeed a main driver of the recent decline in the aggregate TFP growth rate.

We calculate the sectoral TFPs for the agricultural, industrial and service sectors since 1978 (see Figure 11), with output measured using either the value-added or the final expenditure approach. As can be seen from the figure, under either approach, on average TFP is much lower in the service sector than in the other two sectors.

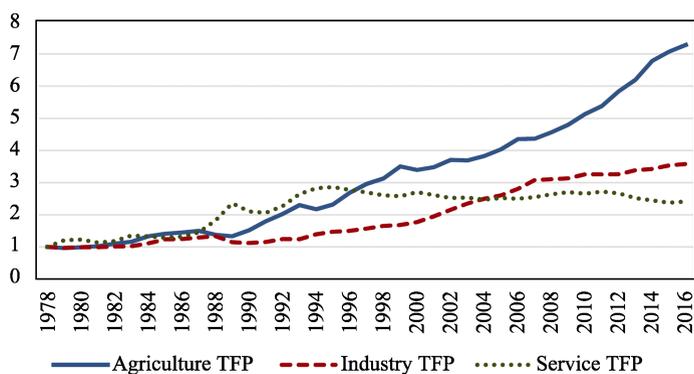


Figure 11 TFP of Agriculture, Industry and Service

Source: IAR SUFE.

The main factor behind the divergence in sectorial TFPs is capital misallocations discussed above and financing discrimination between SOEs and non-SOEs, which are exacerbated by a GDP-based performance evaluation system for local government officials. Besides the aforementioned capital misallocations between agricultural and non-agricultural sectors and between industrial and service sectors, there are also substantial capital misallocations within the service sector as well as discriminations in many service sub-sectors, which are exacerbated by the directives of state-owned capital. More specifically, local governments have strong incentives to invest in capital-intensive sectors and sub-sectors, such as infrastructure and transportation, in order to meet short-run growth or employment targets, with such projects carried out mainly by SOEs that have the advantages over non-SOEs in receiving cheap loans from the banking system. The capital overhang in the SOE-dominated service sector results in not only a much lower return on capital in the service sector than in the industrial sector, but also immense risks on local government debt, whereas it crowds out private investment due to the associated misallocation of financial resources. On the other hand, some labor-intensive service sub-sectors, such as education, medical services and recreational services, are highly regulated by the government with discriminative obstacles for private enterprises and barriers to the entrance of private capital. Underinvestment in these service sub-sectors as a result deters the household consumption upgrading process.

There are many other frictions and impediments associated with unbalanced and inadequate development, such as barriers to labor mobility, that we have paid close attention in both our past and the present reports. All of these show the urgency for deepening reforms. The past experience of China's rapid post-reform growth and development shows the importance of deregulation, removal of administrative barriers and the introduction of competition to maintain economic dynamism.

Looking forward, deepening reforms should target on removing the institutional barriers in the factor markets and the financial system. Effective measures should be taken unswervingly to remedy resource misallocations, to promote the marketization and competition in the service sector, to eliminate financing discrimination, to further land reform, to orderly implement a property tax system, and to gradually relax the restrictions on labor mobility imposed by the household registration system. All these reforms are critical for the pursuit of

healthy and sustainable growth and of balanced and adequate development, and are also indispensable for a more prosperous society.

4 Reform and Governance

“The principal contradiction facing Chinese society... is the contradiction between unbalanced and inadequate development and the people’s ever-growing needs for a better life,” as President Xi Jinping delivered in the report at the 19th National Congress of the Communist Party of China (CPC). Persistent economic deceleration induced by low-quality and non-sustained development, unequal distribution of public economic resources, social imbalances and injustice, coexistence of overreaction of government and administrative omission, all these incarnations of the main contradiction reflect the dilemma of traditional governance model with strong government, small market and weak society, and the necessity of a well-functioning national governance system of government, market and society.

Especially at this time China urgently moves from the old factor-driven model to the new efficiency-and innovation-driven model of growth and development after a remarkable period of rapid growth. A key step in this transition is to promote economic inclusion to boost the vitality of various market entities, especially private enterprises. China has a long way to “concentrate on improving the property rights system and ensuring the market-based allocation of factors of production”. In addition to implementing administrative measures associated with supporting the development of private enterprises, it is also necessary to deepen the reform of state capital, eliminate administrative obstacles and introduce competition mechanisms in service industry to unleash economic dynamism. All of these institutional reforms are helpful for rebalancing China towards a more sustainable and healthy growth trajectory.

However, this is no easy task. The government needs to transform its functions, further streamline administration, delegate powers, and ultimately transform itself into a service-oriented government, under the guidance of the idea of limited government. Specifically, the government should let the market play a decisive role as long as the market works effectively, and intervene only when markets fail to do what is necessary. Moreover, not as a “night-watchman”, the government should be proactive in initiating, directing and coordinating reforms, establishing and improving a modern market system to stimulate and facilitate

innovation and promote development, launch market-enhancement industrial policy and support emerging industries. Even in this moment of intervention, the establishment of institutional arrangements is a more appropriate approach than to intervene directly.

The punchline of our analyses in this annual report should be taken as to emphasize the critical importance of deepening fundamental reforms, strengthening institutional improvement, implementing a new development philosophy, improving the protection for property rights, and ensuring the mobility of factors, but not specific industrial policies, to the transition from high-speed growth to high-quality growth to achieve balanced and adequate development.

5 Concluding Remarks

China has entered into a new phase of emphasizing quality over speed for economic growth and development. While the persistent economic slowdown in recent years is both cyclical and secular, procrastination of reforms in some of China's key macroeconomic landscapes plays a key role in addition to external factors. China has marched a long way in opening up its economy and reforming its institutions in its mission to transform itself into a modern free market economy and regulatory state. This has led to unprecedented achievements over the past forty years. The country is once again at a crossroad. At this critical stage of transition, the Chinese people and government should be decisive to continue along this unmistakable trend.

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