Abstract: The purpose of this paper is to examine the possibility that China will have an economic crisis in the near future. Although it experienced spectacular growth through the downturn, boosting the world economy, China adopted an extremely unbalanced pattern of growth. We analysed what are the main imbalances of the Chinese economy and we identified the implications of a possible slowdown, as well as future solutions for the Chinese policymakers. The paper offers a complete view and a better understanding of the need to implement immediate reform in order to obtain sustainable development and to avoid a deep economic crisis.

Key words: China, financial crisis, Asian development model, economic growth, investments

JEL classification: F02, G01, O11, O53

1. Introduction
What happens in China doesn’t stay in China, but influences the entire world. It is well known that in the last 30 years, China emerged from an underdeveloped country to a new economic superpower. With an average growth rate of 10 percent per year, China became the second largest economy in the world in 2010 (The Economist, 2010) and it is expected to surpass the United States and become the largest economy by 2020 (Maddison, 2007). The general opinion is that China is indestructible. While in other parts of the world, like the European Union or the United States, the governments are struggling to overcome the economic crisis’ effects, China seems untouched by the financial turmoil. Moreover, it seems like the financial crisis has further raised China’s importance in the world economy, as it is said to have about $2 trillion in foreign currency reserves, especially US dollars. The Chinese governments’ $586 billion stimulus package demonstrated its determination to keep the crisis away, maintain a robust growth through the downturn. But does this mean that China is free of problems? The financial crisis posed serious questions to the Chinese government: how to effectively stimulate domestic consumption? How to maintain sustainable development? The government faces huge pressure to maintain the 8 per cent growth rate of its GDP, because failure to do so would bring huge social problems.

In this paper we analyze the main imbalances of the Chinese economy and we try to identify the implications of a possible slowdown on China and on the rest of the world, as well as future solutions for Chinese policymakers. The rest of the paper is organized as follows. Section 2 reviews the possibility of China having an economic crisis by analyzing the three main drivers of its economic imbalances. In section 3 we present some possible implications of an economic crisis on China and on other countries and we identify possible measures for avoiding the crisis. The concluding remarks are presented in section 4.

2. Will China have an economic crisis?
China is in certain ways unique: it is the only giant country in history that grew so fast and, moreover, it is also a communist country, where the state and not the market allocate the resources. As it is difficult to find a valid precedent, most economists and policymakers claim that it is almost impossible to estimate its future evolution. Some of them are convinced that China’s „state capitalism” is superior to other forms of organization in dealing with crisis, while others sustain that this state control will not last and in the end a systemic change will be needed.

Nevertheless, I do not necessarily agree with this, as I noticed in China’s evolution a certain pattern. China adopted a kind of Asian development model, a model invented by Japan in 1950s and followed by other East Asian countries. There is no agreed definition of what exactly the Asian development model is, but generally and in a simplistic way, it implies the following characteristics (Boltho and Weber, 2009; Stiglitz, 1996; World Bank, 1993): 1) rapid growth using low wages, mainly based on exports and investments through bank financing; 2) high savings rate; 3) high external
competitiveness obtained by protectionist policies; 4) major state implication deliberately encouraging certain sectors.

The model is efficient in the short run, as it generates immense economic growth, but in the end it collapses, as it happened to Japan in 1990 or to South Korea, Taiwan, and Singapore in 1997-1998. The reason is the unbalanced pattern of growth in all this countries. In order to urge massive investments, the state subsidizes certain sectors it considers more attractive. The state redirects immense sums of public money for these industries or encourages banks to lend them cheap money. In this way, a lot of money is pumped into industrialization, generating double digit growth rates. As there is no need to be profitable, a lot of resources are misallocated and this leads to bad investment in fixed assets, which are neither useful, nor profitable. In the end, this generates a wave of bad loans and the banking sector collapses. And China is not far from this pattern...

2.1 Growth at any cost
At the press conference following the close of the annual meeting of China’s legislature in March 2007, Premier Wen Jiabao made an astounding statement, saying: „China’s economic growth is unsteady, unbalanced, uncoordinated and unsustainable”. And this is remarkable for two reasons: first, because China had a growth pace averaging 10 percent for three decades and second because he was in charge of the economy for previous 5 years.

Before the current crisis, China experienced a paradoxical pattern of growth: rapidly rising inflation, combined with a huge number of bankruptcies, revealing the structural problem. China’s spectacular growth had two main drivers. On one hand, there were investments, especially in infrastructure and industry. China developed important infrastructure projects such as highways, bridges and ports, which became the pillar of its development. The second driver of China’s rapid growth was the export of low-end manufactured goods such as clothes and toys, obtained through cheap labour. But wages had been rising for a long time, so the returns started to diminish. In the beginning, foreign investors looked primarily to China when investing in these industries, but as labour costs continued to skyrocket, they started to leave China in favour of cheaper places like Vietnam, Bangladesh or Sri Lanka.

As China’s economy is slowing down, it is almost generally agreed that the booming years are coming to an end. Growth rate already slowed down to 8.9% in the last quarter of 2011, going below double digit. In March 2012, premier Wen Jiabao sent a shockwave through the global economy when lowered the country’s GDP growth target for 2012, to 7.5% from 8%. Moreover, the latest five-year plan targets 7% annual GDP growth (Bloomberg, 2012). By doing so, the premier acknowledges that the effects of the economic crisis are also felt in the Chinese economy, but also that the country’s growth model has to be changed.

But in reality, there is no sign that Chinese economy will slow down to 7%, or that the government will allow this to happen. Even the latest performance, of 8.9%, was well beyond the government’s target, but not enough for the Chinese leadership. The central bank has already started to loosen credit by lowering the reserve requirements for banks in December 2012, a measure which may add approximately $55 billion to the financial system (Bloomberg, November 30, 2012).

2.2 Misguided investments
Between 2003 and 2008, China experienced superheated growth, relying on heavy government-directed investment financed by state-run banks. The investments were mainly headed towards constructions and acquisition of capital equipment. But this rapid growth was based on an extremely unbalanced pattern of development. Investment as a share of GDP was sustained at over 40 percent (see Figure 1), while household consumption fell to only 36 percent of GDP (the remainder went to government consumption and net exports). (Bergsten, Freeman, Lardy and Mitchell, 2009) The high rate of investment has been driven partly by the state banks offering low interest rates, as well as there being low prices for complementary factors of production to physical capital such as land and energy.
After the current financial crisis began, there were significant declines in residential investment and private investment targeted on export markets (China Watch Report, 2009). In order to maintain growth at the same pace, China responded with the world’s first major stimulus program, which was largely dedicated to infrastructure projects. The package would finance public transport infrastructure, affordable housing, rural infrastructure, environmental projects, technological innovation, health and education, and rebuilding areas hit by disasters (such as areas that were hit by the May 12, 2008 earthquake, primarily in Sichuan province).

But in this way, China’s economy became even more reliant on investment. It is estimated that in 2011, investment represented over 54% of the country’s GDP (CIA World Factbook). There are economists who claim that the level is not so high, considering the fact that China is a large developing country which needs a lot of investment in buildings and infrastructure in order to catch up the developed countries. And the argument can be correct. The question is not if the level is too high, but if the investments are made in the right direction. Especially after the implementation of the stimulus package, when investment had to be made so rapidly, it is suspected that a lot of poor investment decisions were taken. For example, the country is investing hundreds of billions in high-speed railways even though ticket prices are beyond the reach of most Chinese, while many major Chinese cities do not have subways (Schuman, 2012).

An important part of Chinese investments are directed towards real estate. Whenever an economy is flooded by excess liquidity, the prices of assets like real estate and stocks rise. Excess money has to go somewhere. When the amount of liquidity is exceptional, the rise of asset prices is similarly exceptional. It is estimated that millions of apartments and thousands of other investment properties are empty, the market being already saturated. Massive new projects are still under construction and this new wave of completed units that will be dumped on the market in 2012 and will probably create major turbulence in the housing sector and perhaps the economy. The government is now ready to intervene, as some fundamentals, such as price-to-income ratio is extremely disproportionate. An average apartment in a Chinese city is 8-10 times the average income, while in 2005, during the US housing bubble, the ratio was 5.1 (Deloitte, 2012). Property prices had already decreased in the last three months of 2011 in the largest 100 Chinese cities, after Beijing has taken an array of steps including introducing a modest property tax and raising mortgage rate and down payments (Deloitte, 2012).

Even worse, much of the investment in China is being financed with debt. Huge amount of new loans appeared on bank’s balance sheet, especially after the adoption of the stimulus package. Bank loans increased by 22% year-on-year in the first quarter of 2009, quite notable in a period of considerable financial de-leveraging in the rest of the world (Petri and Plummer, 2009). A number of commentators have noted that banks cannot possibly be doing serious risk and return evaluations for the vast quantity of loans they have approved, causing an impressive portfolio of non-performing loans in the future. It was already reported that the government has ordered banks to roll over the $1.7 trillion of loans owed by local governments (Financial Times, 2012).
It is quite obvious that there are signs of a crisis. Excessive, misallocated investments leading to a property boom, financed by debt and state intervention, this is a pattern followed by other countries which adopted the Asian development model. The economy needs to rebalance away from investment and exports to a more consumption-driven growth model with a primary focus on quality of growth, not high rates at any cost. But until now, all the measures that had been taken only managed to push China even deeper into the Asian development model, which is, as I argued before, the road to crisis.

2.3 High level of savings
The high and rising aggregate saving and thus the low and declining share of consumption in the GDP constitute a central feature of the Chinese economy and have long been a topic of discussion. In fact, when it comes to Chinese savings, scholars refer to it as “the savings puzzle”. One popular theory relates the high level of saving rate to cultural values, as Chinese people are known to be thrifty. But little evidence exists, and moreover savings rates in Japan, country that shares similar values, have fallen significantly as the countries developed (see Figure 2). Other theories hold up much better, including the effects of demographic change, income uncertainty and undeveloped consumer credit markets (Modigliani and Cao, 2004; Chamon and Prasad, 2010; Yang, Zhang and Zhou, 2011).

The main cause of this disproportion is considered to be the need to “save for a rainy day” due to the historically high burden of private health and education spending and the under-developed social protection system. As individuals have to bear a large share of the costs, people feel they have to save almost 50% of their income to cover these expenses, as well as to self-insure against uncertainty, especially regarding future health and pension needs (Time, 2012). If the government would assure adequate medical and social security, people would be less motivated to save and consumption could increase. As Barnett and Brooks (2010) noticed, 1 RMB increase in government health spending would be associated with 2 RMB increase in urban household consumption (or equivalently, 2 RMB decrease in savings). Total (household plus government) consumption could thus increase by as much as 3 RMB depending on the extent that government health spending takes the form of consumption instead of transfers.

Figure 2: Gross domestic savings (% GDP)

![Figure 2: Gross domestic savings (% GDP)](image)

Source: World Bank

3. Possible implications and future solutions
The majority of the economists claim that China’s impressive growth through the downturn somehow rescued the rest of the world. In all the major regions, the share of imports coming from China currently stands at about 10%, with the exception of East and South Asia, for which it is 15%. China is a global presence, penetrating all world regions (di Giovani, Levchencko and Zhang, 2012).

As a major commodities importer, a slower China would likely mean lower prices for oil, iron ore, copper and other raw materials, reducing growth in many emerging markets, especially from Africa and South America. China is also an important partner for the United States, so a slowing China will also
hit the American economy. Since China is the main trading partner for most countries in Asia, a slower China would drag down growth across the region, and thus dampen overall global growth. Robertson and Zu (2010) suggest that China has had a strong positive impact on growth in the world economy, but particularly in Asia. The study shows that growth in China raises GDP in the United States by about 3% over the decade, while gains to Japan and other East Asian countries are much larger at 13% of GDP. In other words, if China’s GDP growth rate declines, just about everybody will feel it.

Moreover, a slower growth rate while maintaining the actual economic model could lead to rising unemployment and social unrest, which could pose serious threat to the actual political system. An 8% growth rate is considered by the majority of China’s policymakers as the minimum at which the unemployment can be held under control. A solution for lowering the pace of growth, while maintaining full employment, would be to encourage the service sector, instead of the manufacturing sector.

But a slowdown is inevitable and also desirable, in order to obtain a healthier, more balanced growth. The actual growth model is creating distortions which could lead to a crisis in the future. Investment levels are too high, especially in the property development sector. Rising costs, especially labor costs, are affecting China’s export competitiveness, another engine of the country’s growth. Huge amounts of probably non-performing loans is placing the health of the banking sector at risk. China needs to shift to a different growth strategy, one based less on investment and exports and more on domestic consumption – the much-promoted “rebalancing”.

The government has options for helping to shift the economy from an investment driven model to one fueled by consumer demand. China should make increasing household consumption its top priority. The most effective way to boost consumption is to increase household income, but the Chinese government should also employ more fiscal resources to provide social welfare, such as education, health care and social safety nets, which could significantly reduce the uncertainties in household expectations about future income and expenditure. Second of all, the Chinese government should not over-rely on maintaining export growth, because declining external demand, rising local wages and soaring protectionist pressures will weaken any measure by which exports are stimulated. Alternatively, China should promote employment by developing the service sector which is labour-intensive, just like the export sector. Overall, we consider that it is time for China to move ahead on politically difficult, painful reforms that could lay the foundation for sustainable growth in the future.

4. Conclusion
The global financial crisis is both a tough challenge and a precious opportunity for China. Although China seemed untouched by the financial crisis, maintaining a robust growth through the downturn, it is more and more obvious that the growth pattern is extremely unbalanced and unsustainable on the long run. During the last decade, China seems to have adopted a series of excesses that characterize the so-called Asian development model. Its spectacular growth relied on two major drivers: export of manufacturing goods obtained through low wages and fixed assets investments financed with debt. In the same time, consumption gradually decreased and savings rate became high and still rising. All these elements pose serious pressure on Chinese leadership to carry out structural adjustment, unless serious crisis threatens one of the biggest economies in the world. A slower economy could impact China by rising unemployment and social unrest, but also other countries from Asia to the United States. Still, a slowdown seems inevitable and Chinese leaders should implement a series of reform in order to boost consumption and decrease the enormous level of savings. One method would be to provide social welfare such as health and education and release these costs from households’ disposable income. A second method would be to move the accent from exports and investments to the services sector. All in all, both economists from around the world and Chinese policymakers agree that such reform could lay the foundation of a sustainable growth in the long run.

5. References


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