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SPECIAL REPORT

CHINA'S ECONOMY

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Pedalling prosperity

Pedalling prosperity

China's economy is not as precarious as it looks, says Simon Cox. But it still needs to change

IN 1886 THOMAS STEVENS, a British adventurer (pictured above), set off on an unusual bicycle trip. He pedalled from the flower boats of Guangzhou in China's south to the pagodas of Jiujiang about 1,000km (620 miles) to the north. He was disarmed by the scenery (the countryside outside Guangzhou was a "marvellous field-garden") and disgusted by the squalor (the inhabitants of one town were "scrofulous, sore-eyed, and mangy"). His passage aroused equally strong reactions from the locals: fascination, fear and occasional fury. In one spot a "soul-harrowing" mob pelted him with stones, bruising his body and breaking a couple of his bicycle's spokes.

A century later the bike was no longer alien to China; it had become symbolic of it. The "bicycle kingdom" had more two-wheelers than any other country on Earth. Many of those bikes have since been replaced by cars—one obvious sign of China's rapid development. But even today the bicycle looms large in the battle for China's soul.

For China's fast-diminishing population of poor people, bikes remain an important beast of burden, piled high with recycled junk. For China's fast-expanding population of city slickers, the bicycle represents everything they want to leave behind. "I'd rather cry in the back of your BMW than laugh on the back of your bicycle," as China's material girls say. Some dreamers in government see a return to the bike as an answer to China's growing problems of prosperity—pollution, traffic and flab. The country's National Development and Reform Commission wants government officials to cycle to work one day a week, though only if the distance is less than 3km.

Even if it is a fading symbol of Chinese society, the bicycle remains a tempting metaphor for its economy. Bikes—especially when heavily lad-

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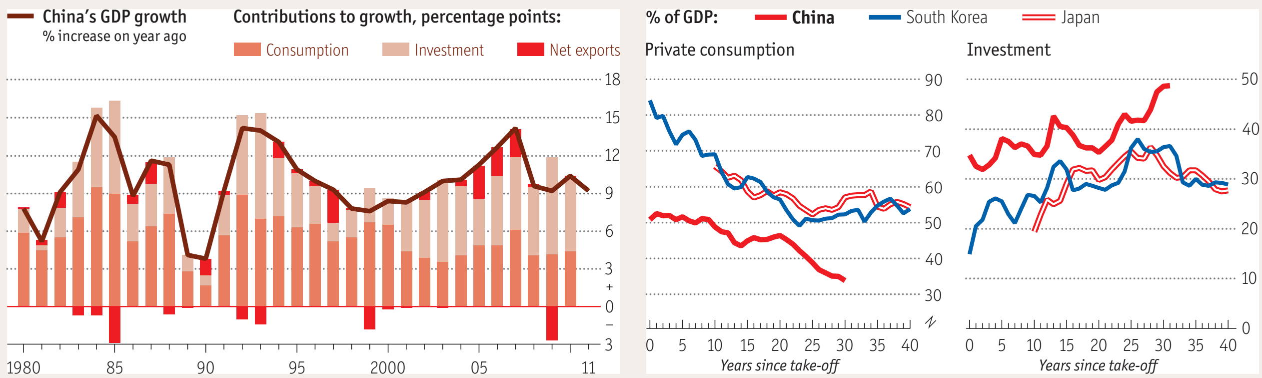
The alchemy of China's growth 1



Source: CEIC

en—are stable only as long as they keep moving. The same is sometimes said about China's economy. If it loses momentum, it will crash. And since growth is the only source of legitimacy for the ruling party, the economy would not be the only thing to wobble. From 1990 to 2008 China's workforce swelled by about 145m people, many of them making the long journey from its rural backwaters to its coastal workshops. Over the same period the productivity of the workforce increased by over 9% a year, according to the Asian Productivity Organisation (APO). Output that used to take 100 people in 1990 required fewer than 20 in 2008. All this meant that growth of 8-10% a year was not a luxury but a necessity.

But the pressure is easing. Last year the ranks of working-age Chinese fell as a percentage of the population. Soon their number will begin to shrink. The minority who remain in China's villages are older and less mobile. Because of this loss of demographic momentum, China no longer needs to grow quite so quickly to keep up. Even the government no longer sees 8% annual growth as an imperative. In March it set a target of 7.5% for this year, consistent with an average of 7% over the course of the five-year plan that ends in 2015. China has been in the habit of surpassing these "targets", which represent a floor not a ceiling to its aspirations. Nonetheless the lower figure was a sign that the central leadership now sees heedless double-digit growth as a threat to stability, not a guarantee of it.

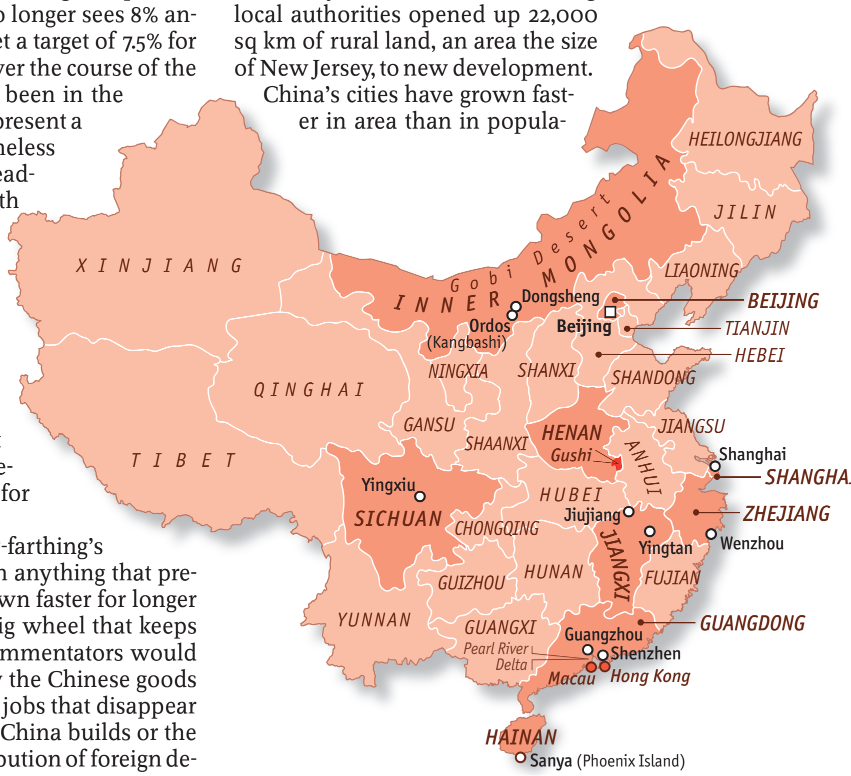
The penny-farthing theory

Stevens's 1886 journey across south-east China was remarkable not only for the route he took but also for the bike he rode: a "high-wheeler" or "penny-farthing", with an oversized wheel at the front and a diminutive one at the rear. The contraption is not widely known in China. That is a pity, because it provides the most apt metaphor for China's high-wheeling economy.

The large circumference of the penny-farthing's front wheel carried it farther and faster than anything that preceded it, much as China's economy has grown faster for longer than its predecessors. Asked to name the big wheel that keeps China's economy moving, many foreign commentators would say exports. Outside China, people see only the Chinese goods that appear on their shelves and the factory jobs that disappear from their shores; they do not see the cities China builds or the shopping aisles it fills at home. But the contribution of foreign demand to China's growth has always been exaggerated, and it is now shrinking.

It is investment, not exports, that leads China's economy. Spending on plant, machinery, buildings and infrastructure accounted for about 48% of China's GDP in 2011. Household consumption, supposedly the sole end and purpose of economic activity, accounts for only about a third of GDP (see chart 1). It is like the small farthing wheel bringing up the rear.

A disproportionate share of China's investment is made by state-owned enterprises and, in recent years, by infrastructure ventures under the control of provincial or municipal authorities but not on their balance sheets. This investment has often been clumsy. In the 1880s, according to Stevens, China showed a "scrupulous respect for individual rights and the economy of the soil". The road he pedalled took many wearisome twists and turns to avoid impinging on any private property or fertile plot. These days China's roads run straight. Between 2006 and 2010 local authorities opened up 22,000 sq km of rural land, an area the size of New Jersey, to new development. China's cities have grown faster in area than in popula-



Keep those wheels turning

tion. This rapid urbanisation is a big part of the country's economic success. But it has come at a heavy price in depleted natural resources, a damaged environment and scrupulously disrespected property rights.

The imbalance between investment and consumption makes China's economy look precarious. A cartoon from the 1880s unearthed by Amir Moghaddass Esfehani, a Sinologist, shows a Chinese rider losing control of a penny-farthing and falling flat on his face. A vocal minority of commentators believe that China's economy is heading for a crash. In April industrial output grew at its slowest pace since 2009. Homebuilding was only 4% up on a year earlier. Things are looking wobbly.

But China's economy will not crash. Like the high-wheeled penny-farthing, which rolled serenely over bumps in the road, it is good at absorbing the jolts in the path of any developing country. The state's influence over the allocation of capital is the source of much waste, but it helps keep investment up when private confidence is down. And although China's repressed banking system is inefficient, it is also resilient because most of its vast pool of depositors have nowhere else to go.

Not so fast

The penny-farthing eventually became obsolete, superseded by the more familiar kind of bicycle. The leap was made possible by the invention of the chain-drive, which generated more oomph for every pedal push. China's high-wheeling growth model will also become obsolete in due course. As the country's workforce shrinks and capital accumulates, its saving rate will fall and new investment opportunities will become more elusive. China will have to get more oomph out of its inputs, raising the productivity of capital in particular. That will require a more sophisticated financial system, based on a more complex set of links between savers and investors.

Other innovations will also be needed. China's state-owned enterprises emerged stronger—too strong—from the downsizing of the 1990s, but the country's social safety net never recovered. Thus even as the state invests less in industrial capacity, it will need to spend more on social security, including health care, pensions, housing and poverty relief. That will help boost consumer spending by offering rainy-day protection.

The chain-drive was not the only invention required to move beyond the penny-farthing. The new smaller wheels also needed pneumatic tyres to give cyclists a smoother ride. In the absence of strong investment to keep employment up and social unrest down, China's state will also need a new way to protect its citizens from bumps in the road ahead. ■

Exports

The retreat of the monster surplus

China's current-account surplus is on the verge of extinction

THREE DINOSAURS LURK in a former factory district of Beijing. Bright red, with "Made in China" embossed on their bellies, they look like the cheap plastic toys China exports to the rest of the world. But these model dinosaurs are life-sized, towering over passers-by. And they look hungry.

The three beasts are one of the imposing installations at the 798 Art District in Beijing. Sculpted by Sui Jianguo, a former factory worker, they are imprisoned in three cages, stacked on top of each other, like the 20-foot containers that carry the country's manufactures to the world. In resin, bronze and steel, the sculpture embodies the widespread fear that China's exporters will gobble up foreign markets and manufacturers. When it was made in 1999, the country's exports were less than a third of America's. Ten years later China was the world's largest exporter. Of the toys shipped to America and the European Union, 85-90% were made in China.

The country's roaring exports contributed to a growing current-account surplus, which exceeded 10% of its GDP in 2007 (see chart 3, next page). China's surpluses—its failure to import as much as it exported, spend as much as it earned, or invest as much as it saved—became an economic *cause célèbre*, generating an equally impressive surplus of commentary and explanation.

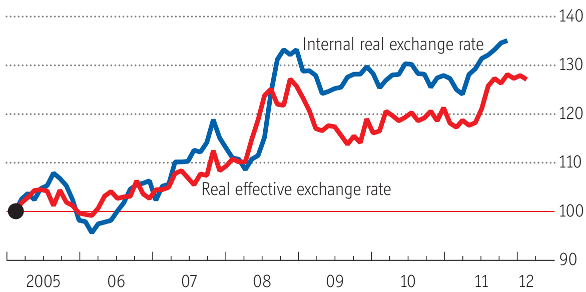
Ben Bernanke, now chairman of America's Federal Reserve, argued that China's surplus was adding to a "global savings glut". It was the subject of much debate and diplomacy at G20 summits, and the object of much blame and many bills in America's Congress. The latest of those, which passed the Senate in October, calls for retaliation against any country that engineers an oversized surplus with an undervalued currency. Mitt Romney, the presumptive Republican nominee for president, has threatened to brand China as a currency manipulator on his first day in the White House.

China's trade surplus with America remains large and controversial, but its current-account surplus with the rest of the world is dying out. Last year it narrowed to $201 billion, less than

Safely caged

Less cheap 2

China's exchange rate, March 2005=100



Sources: Hong Kong Institute for Monetary Research Working Paper; BIS

2.8% of the country's GDP, the smallest percentage since 2002. In money terms it was smaller than Germany's.

Is that small enough? The Senate bill relies on IMF methods to calculate a current-account "norm" for a country like China. Such calculations are more art than science: one exercise by the European Central Bank estimated China's norm 16,384 different ways. But an unofficial study using the IMF's methods calculated a benchmark of about 2.9% of GDP over the medium term, which suggests China's surplus is about where it should be. Whether it remains there depends partly on why it narrowed in the first place. In its latest *World Economic Outlook*, the IMF identifies four reasons: China's exchange rate, its terms of trade, global spending and China's own investment expenditure.

The future of China's export monster depends on whether China's high investment rate is sustainable. Many think it is not

China's exchange rate has risen, if not as far or as fast as many Americans had hoped. This appreciation can be measured in various ways. The measure most economists watch is the real effective exchange rate (REER) adjusted for consumer-price inflation and weighted by trade. This has gone up by 27% since July 2005. An alternative gauge is the internal real exchange rate (IRER), which measures the price of Chinese goods that cannot be traded across borders relative to the price of things that can. According to a study by the Hong Kong Institute for Monetary Research, China's internal real exchange rate rose by over 35% between July 2005 and December 2011 (see chart 2). This appreciation encourages the Chinese to make more non-tradable goods and to buy more tradable ones. Both help narrow its surplus.

The size of China's surplus also depends on some volatile prices, such as the cost of crude oil and other commodities that China imports. The price of China's imports has risen relative to the price of its exports in recent years. According to the IMF, this deterioration in China's terms of trade could explain up to half the drop in its surplus between 2007 and 2011. Those terms are unlikely to improve. As long as China remains the dominant force in the market for its main imports and exports, it will continue to influence the price of both.

This pincer movement shows up in surprising ways. One British scholar argues that cheap Chinese exports have deterred burglaries in his country because a £19.99 DVD player is hardly worth stealing. But others say that China's imports of copper have contributed to a rise in metal theft because China's appetite for such commodities has made them a more tempting target.

Domestic demand in China's big trading partners has been slow to recover from the crisis. China's own spending, on the other hand, has surpassed all expectations. Investment as a share of GDP rose by over six points between 2007 and 2010 as banks lent liberally to help stimulate the economy. The IMF reckons that this rise in investment in itself accounted for between a quarter and a third of the narrowing of China's surplus. But it may also have been a contributory cause of some of the other factors, such as the rise in commodity prices and the increase in Chinese wages and prices.

Will it return?

The surplus could widen again, for one of two reasons. First, China's high investment could set the stage for a renewed export boom. Second, China's investment rate could falter without consumption rising to make up for it, forcing China to rely on foreign demand to keep the economy moving.

To imagine the first scenario, you only have to examine the recent past. Pieter Bottelier of the Conference Board, a think-tank, argues that China's big surpluses before 2008 owed something to an investment boom around the time China joined the World Trade Organisation in 2001. This investment created excess capacity in industries such as cars, construction materials and especially steel. At first these new factories displaced imports; then, when the domestic market proved too small, they flogged their surplus wares on foreign markets instead. China went from being a net importer of steel in 2004 to being the world's largest net exporter, note Brett Berger and Robert Martin of the Federal Reserve.

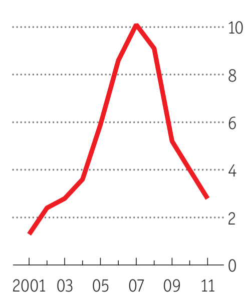
But a repeat is unlikely. It would require China's low consumption rate to move still lower to make room for so much investing and exporting. It would also require China to make further rapid gains in global market share.

The post-crisis investment boom was also different from the post-WTO one. It was weighted towards inland provinces, far from the seaports that ship China's goods to the rest of the world. Inland China's share of fixed-asset investment matched that of the coastal provinces for the first time in 2009, then exceeded it in 2010. The investment boom in 2009-10 was also concentrated in infrastructure and property. Neither can be traded across borders.

But some economists believe that the latest investment boom will prove unsustainable. If construction collapses, some of the industries that fed China's building rush will turn their attentions overseas, as they did in 2006.

Back where it belongs 3

China's current-account surplus
As % of GDP



Source: CEIC

The future of China's export monster thus depends on whether China's high investment rate is sustainable. Many think it is not. Economists like Paul Krugman, a professor at Princeton University and a commentator for the *New York Times*, have gone from bashing China for its underpriced currency to fretting about its overpriced property. Its spectacular building boom has diverted China's energies inwards, sucking in imports and displacing exports. It has thus eased the world's fear of China. But it has raised fears for China. ■

Investment

Prudence without a purpose

Misinvestment is a bigger problem than overinvestment

GENGHIS KHAN SQUARE in Kangbashi, a new city in the northern province of Inner Mongolia, is as big as Tiananmen Square in Beijing. But unlike Tiananmen Square, it has only one woman to sweep it. It takes her six hours, she says, though longer after the sandstorms that sweep in from the Gobi desert. Kangbashi, or "new Ordos", as it is known, is easy to clean because it is all but empty. China's most famous "ghost city", it has attracted a lot of journalists eager to illustrate China's overinvestment, but not many residents.

Ordos was one of the prime exhibits in an infamous presentation by Jim Chanos, a well-known short-seller, at the London School of Economics in January 2010. Mr Chanos argued that China's growth was predicated on an unsustainable mobilisation of capital—investment that provides only for further investment. China, he quipped, was "Dubai times 1,000".

His tongue-in-cheek reference to the bling-swept, debt-drenched emirate caused a stir. But not everywhere in China shrinks from the comparison. One property development that actively courts it is Phoenix Island, off the coast of tropical Sanya, China's southernmost city. It is a largely man-made islet, much like Dubai's Palm Jumeirah. Its centrepiece will be a curvaceous seven-star hotel, rather like Dubai's Burj Al Arab, only shaped like a wishbone not a sail. The five pod-like buildings already up resemble the unopened buds of some strange flower. Coated in light-emitting diodes, they erupt into a lightshow at night, featuring adverts for Chanel and Louis Vuitton.

After a visit to Ordos or Sanya, it is tempting to agree with Mr Chanos that China has overinvested from its northern steppe to its southern shores. But what exactly does it mean for a country to "overinvest"? One clear sign would be investment that was running well ahead of saving, requiring heavy foreign borrowing and buying. The result could be a currency crisis, like the Asian financial crisis of 1997-98. Some veterans of that episode worry about China's reckless investment in tasteless property. But although China invests more of its GDP than those crisis-struck economies ever did, it also saves far more. It is a net exporter of capital, as its controversial current-account surplus attests. Indeed, for every critic bashing China for reckless investment spending there is another accusing it of depressing world demand through excessive thrift. China is in the odd position of being cast as both miser and wanton.

Even an extravagance like Kangbashi is best understood as an attempt to soak up saving. The Ordos prefecture, to which it belongs, is home to a sixth of China's coal reserves and a third of its natural gas (not to mention its rare earths and soft goat's wool). According to Ting Lu of Bank of America Merrill Lynch, Kangbashi is an attempt to prevent Ordos's commodity earnings from disappearing to other parts of the country.

China as a whole saved an extraordinary 51% of its GDP last year. Until China's investment rate exceeds that share, there is no cause for concern, says Qu Hongbin of HSBC. Anything China fails to invest at home must be invested overseas. "The most wasteful investment China now has is US Treasuries," he adds.

When talking about thrift, economists sometimes draw on a parable of prudence written three centuries ago by Daniel Defoe. In that novel the resourceful Robinson Crusoe, shipwrecked on a remote island, saves and replants four quarts of barley. The reward for his thrift is a harvest of 80 quarts, a return of 1,900%.

Castaway capital

Investment is made out of saving, which requires consumption to be deferred. The returns to investment must be set against the disadvantage of having to wait. In Robinson Crusoe, the saving and the investing are both done by the same Englishman, alone on his island. In a more complicated economy, households must save so that entrepreneurs can invest. In most economies their saving is voluntary, but China has found ways of imposing the patience its high investment rate requires.

Michael Pettis of Guanghua School of Management at Peking University argues that the Chinese government suppresses consumption in favour of producers, many of them state-owned. It keeps the currency undervalued, which makes imports expensive and exports cheap, thereby discouraging the consumption of foreign goods and encouraging production for foreign customers. It caps interest rates on bank deposits, depriving households of interest income and transferring it to corporate borrowers. And because some of China's markets remain largely sheltered from competition, a few incumbent firms can extract high prices and reinvest the profits. The government has, in effect, confiscated quarts of barley from the people who might want to eat them, making them available as seedcorn instead. ▸▸

China's answer to Dubai

Boom, boom

What has China got in return? Investment, unlike consumption, is cumulative; it leaves behind a stock of machinery, buildings and infrastructure. If China's capital stock were already too big for its needs, further thrift would indeed be pointless. In fact, though, the country's overall capital stock is still small relative to its population and medium-sized relative to its economy. In 2010, its capital stock per person was only 7% of America's (converted at market exchange rates), according to Andrew Batson and Janet Zhang of GK Dragonomics, a consultancy in Beijing. Even measured at purchasing-power parity, China has only about a fifth of America's capital stock per person, depending on how its PPP rate is calculated.

China needs to "produce lots more of almost everything", argues Scott Sumner of Bentley University, even if it does not produce "everything in the right order". Its furious homebuilding, for example, has unnerved the government and cast a shadow over its banks, which worry about defaults on property loans. But it still needs more places for people to live. In 2010 it had 140m-150m urban homes, according to Rosealea Yao of GK Dragonomics, 85m short of the number of urban households. About three-quarters of China's migrant workers are squeezed into rented housing or dormitories provided by their employer.

Nor is China's capital stock conspicuously large relative to the size of its economy. It amounted to about 2.5 times China's GDP in 2008, according to the APO. That was the same as America's figure and much lower than Japan's. Thanks to China's stimulus-driven investment spree, the ratio increased to 2.9 in 2010, but that still does not look wildly out of line.

The ballad of Mr Guo

What makes local-government officials tick

SINGING KARAOKE WITH Taiwanese investors, smearing birthday cake on the cheeks of an American factory owner, knocking back *baijiu*, a Chinese spirit, with property developers: Guo Yongchang would do anything to attract investment to Gushi, a county of 1.6m people in Henan province, where he served as party secretary. His antics are recorded in "The Transition Period", a remarkable fly-on-the-wall documentary about his last months in office, filmed by Zhou Hao.

Mr Guo persuades one developer to raise the price of his flats because Gushi people are interested only in the priciest properties. After a boozy dinner he drapes himself over the developer's shoulder and extracts a promise from him to add more storeys to his tower to outdo the one in the neighbouring city.

The one-upmanship exemplified by Mr Guo has generated great economic dynamism, but also great inefficiency. When the central government tries to stop economic overheating, local governments resist. Conversely, when the government urged the banks to support its 2008 stimulus effort, local governments scrambled to claim an outsized share of the lending. The result is a local-government debt burden worth over a fifth of China's 2011 GDP.

The worst abuses, however, involve land. Local officials can convert collectively owned rural plots into land for private development. Since farmers cannot sell their land directly to developers, they have to accept what the government is willing to pay. Often that is not very much.

Such perverse incentives have caused China's towns and cities to grow faster in area than they have grown in population. Their outward ripple has engulfed some rural communities without quite erasing them. The perimeter of Wenzhou city in Zhejiang province, to take one example, now encompasses clutches of farmhouses, complete with vegetable plots, quacking ducks and free-range children. This results in some incongruous sights. Parked outside one farmhouse are an Audi, a Mercedes and a Porsche. Alas, they do not belong to the locals but to city slickers who want their hub caps repainted.

Oddly, where electoral reforms have given Chinese villagers a bigger say in local government, growth tends to slow, according to Monica Martinez-Bravo of Johns Hopkins University and her colleagues. This is partly because elected local officials shift their efforts from expanding the economy to providing public goods, such as safe water. But it is also because a scattered electorate cannot monitor them as closely as their party superiors can.

Fear of their bosses and hunger for revenues keep local officials on their toes. Mr Guo, star of "The Transition Period", was eventually convicted of bribery. He was not entirely honest in the performance of his duties, and not always sober either. But with all the parties, banquets and karaoke, no one could accuse him of being lazy.

Malinvestors of great wealth

In Defoe's tale, Robinson Crusoe spends five months making a canoe for himself, felling a cedar-tree, paring away its branches and chiselling out its innards. Only after this "inexpressible labour" does he find that the canoe is too heavy to be pushed the 100 yards to the shore. That is not an example of overinvestment (Crusoe did need a canoe), but "malinvestment". Crusoe devoted his energy to the wrong enterprise in the wrong place.

It is surprisingly hard to show that China has overinvested, but easier to show that it has invested unwisely. Of China's misguided canoe-builders, two are worth singling out: its local governments (see box) and its state-owned enterprises (SOEs).

China's SOEs endured a dramatic downsizing and restructuring in the 1990s. Thousands of them were allowed to go bankrupt, yet those that survived this cull remain a prominent feature of Chinese capitalism. Even in the retail, wholesale and restaurant businesses there are over 20,000 of them, according to Zhang Wenkui of China's Development Research Centre.

SOEs are responsible for about 35% of the fixed-asset investments made by Chinese firms. They can invest so much because they have become immensely profitable. The 120 or so big enterprises owned by the central government last year earned net profits of 917 billion yuan ($142 billion), according to their supervisor, the State-owned Assets Supervision and Administration Commission (SASAC). It cites their profitability as evidence of their efficiency. But even now, returns on equity among SOEs are substantially lower than among private firms. Nor do SOEs really "earn" their returns. The markets they occupy tend to be uncompetitive, as the OECD has shown, and their inputs of land, energy and credit are artificially cheap. Researchers at Unirule, a Beijing think-tank, have shown that the SOEs' profits from 2001 to 2008 would have turned into big losses had they paid the market rate for their loans and land.

Even if the SOEs deserved their large profits, they would not be able to reinvest them if they paid proper dividends to their shareholders, principally the state. Since a 2007 reform, dividends have increased to 5-15% of profits, depending on the industry. But in other countries state enterprises typically pay out half, according to the World Bank. Moreover, SOE dividends are not handed over to the finance ministry to spend as it sees fit but paid into a special budget reserved for financing state enterprises. SOE dividends, in other words, are divided among SOEs.

The wrong sort of investment

Loren Brandt and Zhu Xiaodong of the University of Toronto argue that China's worst imbalance is not between investment and consumption but between SOE investment and private investment. According to their calculations, if state capitalists had not enjoyed privileged access to capital, China could have achieved the same growth between 1978 and 2007 with an investment rate of only 21% of GDP, about half its actual rate. A similar conclusion was reached by David Dollar, now at America's Treasury, and Shang-Jin Wei of Columbia Business School. They reckon that two-thirds of the capital employed by the SOEs should have been invested by private firms instead. Karl Marx made his case for collective ownership of the means of production in "Das Kapital". Messrs Dollar and Wei called their riposte "Das (Wasted) Kapital".

Perhaps the best that can be said of China's SOEs is that they give the country's ruling party a direct stake in the economy's prosperity. Li-Wen Lin and Curtis Milhaupt of Columbia University argue that the networks linking the party to the SOEs, and the SOEs to each other, help to forge an "encompassing" coalition, a concept they draw from Mancur Olson, a political scientist. The members of such a coalition "own so much of the society that they have an important incentive to be actively concerned about how productive it is". China's rulers not only own large swathes of industry, they have also installed their sons and daughters in senior positions at the big firms.

The SOEs provide some reassurance that the government will remain committed to economic growth, according to Mr Milhaupt and another co-author, Ronald Gilson. The party officials embedded in them are like "hostages" to economic fortune, "the children of the monarch placed in the hands of those who need to rely upon the monarch". That gives private entrepreneurs confidence, because the growth thus guaranteed will eventually benefit them as well—although they will have to work harder for their rewards.

What are the implications of China's malinvestment for its economic progress? At its worst, China's growth model adds insult to injury. It suppresses consumption and forces saving, then misinvests the proceeds in speculative assets or excess capacity. It is as if Crusoe were forced to scatter more than half his barley on the soil, then leave part of the harvest to rot.

The rot may not become apparent at once. Goods for which there is no demand at home can be sold abroad. And surplus plant and machinery can be kept busy making capital goods for another round of investment that will only add to the problem. But when the building dust settles, a number of consequences become clear. First, consumption is lower than it could be, because of the extra saving. GDP, properly measured, is also lower than it appears, because so much of it is investment, and some of that investment is ultimately valueless. It follows that the capital stock, properly measured, is also smaller than it seems, because a lot of it is rotten. That would make for a very different kind of island parable, a tale of needless austerity and squandered effort.

Fortunately there is another side to China's story. It has not only accumulated physical capital but also acquired more know-how, better technology and cleverer techniques. That is why foreign multinationals in the country rely on local suppliers—and also why they fear local rivals. A Chinese motorbike-maker studied by John Strauss of the University of Southern California and his co-authors started out producing the metal casings for exhaust pipes. Then it learnt how to make the whole pipe. Next it mastered the pistons. Eventually it made the entire bike.

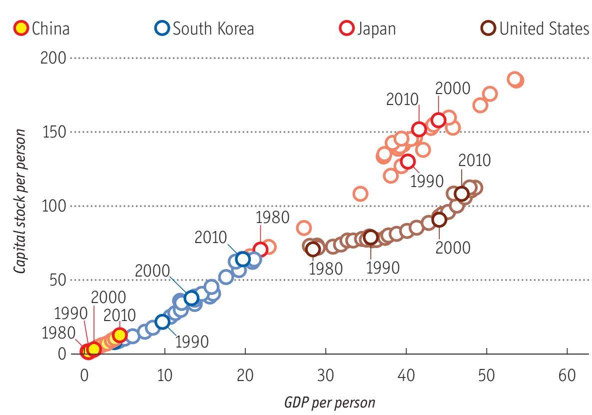
China "bears" like Mr Chanos sometimes neglect this side of the country's progress. In his 2010 presentation he compared China to the Soviet Union, another empire in the east that enjoyed a stretch of beguiling economic growth. Like the Soviet command economy, China is good at marshalling inputs of capital and labour, he pointed out, but China has failed to generate growth in output per input, just as the Soviet Union failed before it. Yet this analogy with the Soviet Union is preposterous.

Economists refer to a rise in output per input of capital and labour as a gain in "total factor productivity". Such gains have many sources. One textile boss got 20% more out of his seamstresses by playing background music in his factory, recalls Arnold Harberger of the University of California at Los Angeles. The striking thing about the growth in China's total factor productivity is not its absence but its speed: the fastest in the world over the past decade. Between 2000 and 2008 it contributed 43% of the country's economic growth, according to the APO. That is just as big a contribution as the brute accumulation of capital, which accounted for 44% (excluding information technology). Thus even if some of China's recent investment has in fact been wasted, China's progress cannot be written off.

And even if some of China's past investment has been futile, adding nothing worthwhile to the capital stock, there is a consolation: it will leave more scope to invest later, suggesting that the country's potential for growth is even larger than the optimists think. The right kind of investment can still generate high returns. But what if the mistaken investments of the past disrupt the financial system, preventing resources from being deployed more effectively in the future? ■

Plenty of upside 4

Net capital stock and GDP per person, constant 2010 $'000



Sources: Asian Productivity Organisation; IMF

Finance

Bending not breaking

The school that became a shrine

China's financial system looks quake-proof, but for how long?

VISITORS TO SICHUAN'S atmospheric mountains, home to both Tibetan and Qiang minorities, used to skip Yingxiu village on their way to more scenic spots higher up. But the devastating earthquake that struck the area in May 2008 has turned the village into an unlikely tourist attraction. The earthquake killed 6,566 people in the village, over 40% of its population. Its five-storey middle school collapsed, killing 55 people. Nineteen students and two teachers remain buried in the rubble.

Four years on, the crumpled school remains. It has been preserved as a memorial to the disaster, but almost every other sign of the quake has been erased. The village is full of new homes with friezes painted in strong Tibetan colours. Other buildings are topped with flat roof terraces, a white concrete triangle in each corner, echoing the white stones that adorn traditional Qiang architecture. The new homes look a little like Qiang stone houses on the outside, one villager concedes. "But inside they are all Han."

Yingxiu is an example of "outstanding reconstruction", according to a billboard en route. Outside this showcase village, people have rebuilt their lives with less government help. But there is no denying that China set about reconstructing the earthquake zone with a speed and determination few other countries would be able to match. A propaganda poster shows Hu Jintao, China's president, bullhorn in hand, declaring that "Nothing Can Stop the Chinese".

The earthquake did great damage to the region's property and infrastructure. But although it left the local economy worse off, the pace of economic activity picked up in the wake of the disaster. There was much to do precisely because so much had been lost. Even today the mountain road is lined with lorries.

Some economists worry that China may soon suffer a different kind of economic disaster: a financial tremor of unknown magnitude. Pivot Capital Management, a hedge fund in Monaco, argues that China's recent investment spree was driven by a "credit frenzy" which will turn into a painful "credit bust".

Lending jumped from 122% of GDP in 2008 to 171% just two years later, according to Charlene Chu of Fitch, a ratings agency, who counts some items (such as credit from lightly regulated "trust" companies) that do not show up in the official figures. This surge in credit is reminiscent of the run-up to America's financial crisis in 2008, Japan's in 1991 and South Korea's a few

Homeric wisdom

Easier cross-border capital flows may help liberalise interest rates

SPEECHMAKERS LIKE TO claim that the Chinese word for crisis (*weiji*) contains the characters for both danger and opportunity. Most linguists dispute this. Either way, China's economic policymakers don't seem to believe it. For them, a crisis is a reason to batten down the hatches.

In 1996 China's government told the IMF that it intended to remove its controls on international capital flows within five to ten years. But when the Asian financial crisis struck a year later, China's government retreated into its shell.

Sixteen years later the timing looks better. Fear of capital outflows has been assuaged by China's vast foreign-exchange reserves. The opposite danger—excessive capital inflows—has also eased. Indeed, the yuan has come under downward pressure at several points in the past year.

Reformers in the government are testing the waters. In April regulators raised the amount that "qualified" foreign investors can venture in the country's securities markets to $80 billion, and eased the limit that similarly qualified Chinese investors can whisk out of the country. The central bank also loosened its grip on the currency a little, widening the yuan's daily band from 0.5% either way to 1%.

China has no obvious need for foreign capital: its own saving is more than enough to meet its investment needs. So liberalisers may have ulterior motives in mind, calculating that external liberalisation will force the pace of domestic financial reform. If capital could move more freely across borders, the authorities would struggle to keep interest rates artificially low—unless they were prepared to let capital flee and the currency fall.

By opening the capital account soon, China could claim several prizes, reformers argue. Its investors could acquire foreign firms at low prices, thanks to European turmoil and American caution. The country could also take advantage of the world's disillusion with the dollar to promote the yuan as an international store of value and medium of exchange.

Eswar Prasad of the Brookings Institution calls this a "Trojan horse" strategy, after the gift horse described by Homer that tricked the Trojans into opening their gates. The reformers' ploy poses some risks. If China opens the capital account before it reforms its SOEs, foreign lending may help feed their investment hunger. An open border would also make it harder to contain a domestic banking crisis. A different Homer put it best. Told that Chinese uses the same word for crisis and opportunity, Homer Simpson exclaimed: "Yes! Crisa-tunity!" A premature opening of the capital account would be just that.

years later (see chart 5), Ms Chu argues. When Fitch plugged China's figures into its disaster warning system (the "macro-prudential risk indicator"), the model suggested a 60% chance of a banking crisis by the middle of next year.

China's frenzied loan-making has traditionally been matched by equally impressive deposit-taking. Even now, most households have few alternative havens for their money. This captive source of cheap deposits leaves China's banks largely shock-proof. They make a lot of mistakes, but they also have a big margin for error. That will help them withstand any impending tremors.

But this traditional source of strength will not last for ever. China's richest depositors are becoming restless, demanding better returns and seeking ways around China's regulated interest rates. The government will eventually have to liberalise rates. That will make China's banks more efficient but also less resilient.

There remains great uncertainty about China's financial exposure. Not all of the country's "malinvestment" will result in bad loans. Some of its outlandish property developments, including the empty flats of Ordos, were bought by debt-free investors with money to burn. By the same token, not all of China's "bad" loans represent malinvestment. Rural infrastructure projects, to take one example, are often "unbankable", failing to generate enough income from fees, charges and tolls to service their financial obligations. But the infrastructure may still contribute more to the wider economy than it cost to provide. That is especially likely for stimulus projects, which employed labour and materials that would otherwise have gone to waste.

But suppose a financial quake does strike China: how will its economy respond? Financial disasters, like natural ones, destroy wealth, sometimes on a colossal scale. But as China's earthquake showed, a one-off loss of wealth need not necessarily cause prolonged disruption to economic activity as measured by GDP. Yingxiu suffered a calamitous loss of people and property, but this was followed by a conspicuous upswing in output (especially construction) and employment.

If this seems counterintuitive, that is because GDP is easily misunderstood. It is not a measure of wealth or well-being, both of which are directly damaged by disasters. Rather, it measures the pace of economic activity, which in turn determines employment and income. Financial distress will damage China's wealth and welfare, almost by definition. The interesting question is whether it will also lead to a pronounced slowdown in activity and employment—the much-predicted "hard landing". To put it in Mr Hu's terms, can a financial quake stop the Chinese?

If the banking system as a whole had to write off more than 16% of its loans, its equity would be wiped out. But the state would intervene long before that happened. Despite the excesses of China's local authorities, its central government still has the fiscal firepower to prevent loans going bad, or to recapitalise the banks if they do. Its official debt is about 26% of GDP (including bonds issued by the Ministry of Railways and other bits and pieces). If it took on all local-government liabilities, that ratio would remain below 60%. Alternatively, it could recapitalise a wiped-out banking system at a cost of less than 20% of GDP.

Even if many loans do eventually sour, banks do not have to recognise these losses all at once. No loan is bad until someone demands repayment, as the saying goes. In March the government released details of a long-rumoured plan to roll over loans to local governments. Many of these loans were due to mature before the project they financed was meant to be completed. If the project is worth finishing, this kind of evergreening is an efficient use of resources. And some projects, once under way, are worth finishing even if they were not worth starting.

Loan rollovers give banks time to earn their way out of trouble, setting aside profits from good loans before they recognise losses on bad ones. This task is easier in China than in other countries because its financial system remains "repressed". Banks can force their depositors to bear some of their losses by paying them less than the market rate of interest. Indeed, deposit rates are often below the rate of inflation, making them negative in real terms. A bank's depositors, in effect, pay the bank to borrow their money from them.

Chinese banks can get away with this because deposit rates are capped by the government, preventing rival banks from offering higher rates. China's capital controls also make it hard for depositors to escape this implicit tax by taking their money abroad. As a consequence, Chinese banks luxuriate in a vast pool of cheap deposits, worth 42% more than their loans at the end of 2011.

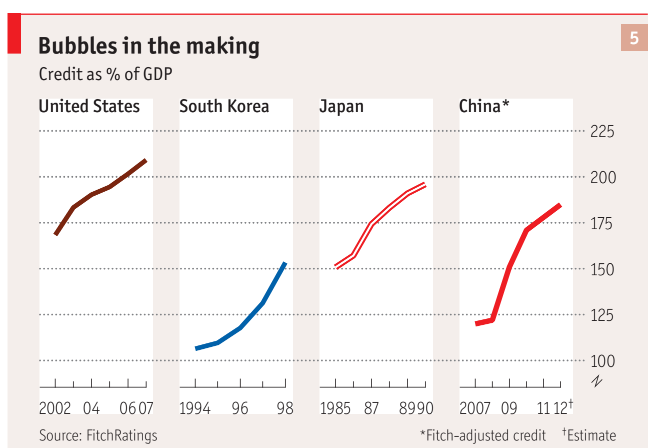
This cash float gives Chinese banks a lot of room for error. In 2011 new deposits amounted to 9.3 trillion yuan, according to official figures, more than enough to cover fresh loans of 7.3 trillion yuan. Although deposit growth is slowing, these inflows give banks a cash buffer, allowing them to keep lending, even if their maturing loans are not always repaid in full and on time.

A chronic complaint

So China's financial strains will not result in the sort of acute disaster suffered so recently by the West. Instead, they will remain a chronic affliction which the state and its banks will try to ameliorate over time with a combination of government-orchestrated rollovers, repression and repayment.

Such a combination is unfair to taxpayers and depositors, but it is also stable. According to Guonan Ma of the Bank for International Settlements, bank depositors and borrowers ended up paying roughly 270 billion yuan ($33 billion) towards the cost of China's most recent round of bank restructuring, which stretched over a decade from 1998. However, some commentators think that China will find it harder to repeat the trick in the future. Depositors are not as docile as they were. In fits and starts, resistance to China's financial repression seems to be growing.

"Let's be frank. Our banks earn profits too easily," Wen Jiabao, China's prime minister, admitted on national radio in April. He is right. The ceiling on deposit rates and the floor under lend-



Bubbles in the making

Source: FitchRatings

To avoid repressed interest rates, savers have overpaid for alternative assets such as property, contributing to China's worrying speculative bubble

ing rates guarantee banks a fat margin, preventing competition for deposits and allowing big banks to maintain vast pools of money cheaply.

If the deposit ceiling were lifted, small banks would offer juicier rates to take market share from incumbents. Conversely, the big banks would trim their deposit bases as they became more expensive. Households would be better rewarded for their saving, and China's banking "monopoly" would be broken, as Mr Wen professes to want. In fact, though, the government is still dragging its feet on rate liberalisation. Its hesitancy may reflect the political clout of the state-owned banks. It may also reflect the government's own fears.

Most developing countries (and some developed ones too) that freed up their financial systems suffered some kind of crisis afterwards. Upstart firms can poach the incumbents' best customers, threatening their viability but at the same time overextending themselves. Even in America, rate liberalisation in the early 1980s allowed hundreds of Savings and Loan Associations to throw their balance sheets out of joint, offering higher returns to depositors even though their assets were producing low fixed returns. In a 2009 paper, Tarhan Feyzioglu of the IMF and his colleagues strongly endorsed Chinese rate liberalisation. But they also acknowledged that it can be mishandled, citing America's S&L crisis as well as even worse debacles in South Korea, Turkey, Finland, Norway and Sweden. The most famous study of these risks was written more than 25 years ago. Its sobering title was "Goodbye Financial Repression, Hello Financial Crash".

The risks of repression

These are good reasons for caution, but not for procrastination. Repressed rates have their own dangers. To avoid them, savers have overpaid for alternative assets such as property, contributing to China's worrying speculative bubble. In places like Wenzhou, a city in Zhejiang province, rate ceilings have encouraged firms and rich individuals to make informal loans to each other, bypassing the regulated banking system in favour of unsafe, unprotected intermediation in the shadows (see box). The patience of the public at large is also wearing thin. At a central-bank press conference in April, a journalist (from Xinhua, the official mouthpiece, no less) refused to let go of the microphone until her complaint about negative deposit rates was heard.

A growing number of depositors are looking for ways to circumvent the ceiling. Those with lots of money to park are driving the demand for "wealth-management products", short-term savings instruments backed by a mix of assets that offer better returns than deposit accounts.

By the end of the first quarter of 2012 these products amounted to 10.4 trillion yuan, according to Ms Chu of Fitch. That is equivalent to over 12% of deposits. Most had short maturities, leaving buyers free to shop around from month to month. Banks accustomed to sitting on docile deposits may struggle to match the timing of cash pay-outs and inflows, Ms Chu frets. The banking regulator may also be worried. It has now banned maturities of less than a month.

The recent proliferation of wealth-management products

Shades of grey

Wenzhou's shadow banking system has taken a knock

THE SMALL-BUSINESS association of Wenzhou, a city in Zhejiang province renowned for its scrappy entrepreneurialism, used to inhabit spartan premises in the city centre, but in March it graduated to plusher offices 15 floors up on the fringes of the city. It is a sign that Wenzhou's brand of wheeler-dealer capitalism is being spruced up.

The desk of Zhou Dewen, the association's head, must be ten feet long. But he still does most of his talking on the couch or in a nearby restaurant where he entertains visiting businessmen. In his office, Mr Zhou hears a pitch from Mao Shuhui, who runs the province's first and only etiquette company. Her clients include the local tax office and a number of mostly state-owned banks. Their staff sometimes need a few pointers, she says. Their hair can be messy and their gestures impolite. Placing a finger on each corner of her mouth, she teaches them how to smile as though they mean it.

However wide their grins, China's banks have not been much help to most Wenzhou entrepreneurs. Long-established firms like Ritai, the shoe-manufacturing outfit run by Mr Zhou's deputy, Jin Zhexin, can get a loan if it is guaranteed by a more creditworthy enterprise. But most Wenzhou entrepreneurs have turned elsewhere. Businessmen with money to spare lend it directly to firms in need, without a bank as middleman. Wenzhou's shadow financial system amounted to 110 billion yuan in 2010, according to one estimate, equivalent to 38% of the city's GDP.

In escaping China's financial repression, however, the city's informal lending system also ducked out of its financial safety system, including its prudential safeguards and its lender of last resort. As the central bank tightened credit in 2010 and 2011, desperate borrowers drew too heavily on grey finance, taking loans they could not repay. Some simply fled. Unnerved, informal lenders began calling in their loans and refusing new ones. The crisis fed on itself. Eventually the government cracked down on borrowers and lenders alike, so the money dried up completely.

In Wenzhou's Fortune Centre, where the most successful lenders once congregated, all that is left of one shadow financier are the indentations on a plaque where its name used to be. In another office, an erstwhile private lender has gone for a completely different sort of business, investing 10m yuan in a TV spy caper set during the Japanese occupation. He wears a Dennis Hopper T-shirt and keeps cans of Budweiser in the office fridge. In the past he could arrange a loan with a single telephone call. Now "the trust is destroyed."

In the absence of trust, lenders demand more tangible collateral. The manager of Dongkai Pawnshop says his business has benefited from the crisis. People who could previously borrow on the strength of their relationships must now offer something solid, like the 100g gold bar commemorating the Beijing Olympics that is for sale in the lobby.

In March the central government unveiled a number of sensible reforms to tame the Wenzhou system without crushing it. Informal lenders will henceforth need to be registered, more private capital will be encouraged and the issuance of high-yield bonds approved. Yet the government still resists the more elegant solution to the problem proposed by Mr Zhou: allowing borrowers and lenders the freedom to set whatever interest rate they like.

amounts to a de-facto liberalisation of interest rates, Ms Chu argues. The growing competition for deposits is showing up in other ways too. When the finance ministry auctions its own six-month deposits, banks are now willing to offer rates as high as 6.8%, more than twice the maximum they are able to offer to ordinary depositors.

The government may seek to formalise this de facto liberalisation, gradually allowing banks more freedom to set rates on large long-term deposits—the kind that will otherwise disappear from banks' books. Net corporate deposits, for example, did not grow at all in 2011. Higher rates would help attract them back.

That would also raise banks' costs of funding, forcing China to become more efficient in its allocation of capital. At the moment the system is segregated between big enterprises, which enjoy relatively low borrowing costs, and credit-starved private firms that could potentially earn much higher returns on investment. In a freer financial system, competition would begin to close this gap. If interest rates went up to match the return on capital, Chinese investment would fall by 3% of GDP, according to a study by Nan Geng and Papa N'Diaye of the IMF.

More flexible interest rates would also raise Chinese consumption, says Nick Lardy of the Peterson Institute for International Economics. He calculates that if banks paid something resembling a market interest rate on their vast deposits, household income would increase by 2% of GDP. Higher incomes, he argues, would cause their spending to rise and their saving rate to fall. The idea that higher rates will make people save less is unorthodox, but Mr Lardy argues that the higher income from saving will have a bigger effect than the higher reward offered for it. Chinese households save towards a goal, he suggests, such as the down-payment on a house or the cost of a potential medical emergency. Lower the return to saving, and they will just save even harder to achieve their goal.

Research by Malhar Nabar of the IMF suggests that higher interest rates would indeed bring down saving rates, but the effects would be modest. If the real rate on one-year deposits rose from roughly 0% today to a more reasonable 3%, it would lower household saving by only about 0.5% of GDP, he calculates. But if higher interest rates alone will not liberate Chinese consumption, what will? ■

Consumers

Dipping into the kitty

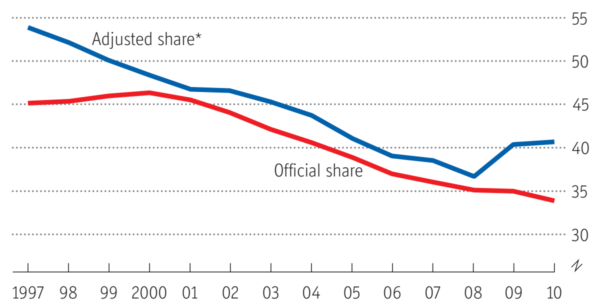
Chinese consumption is about much more than shopping

ZHANG GUIDONG GREW up on a farm in Anhui, a poor inland province, where China's economic reforms made a humble beginning. He left home for Beijing in 1995 with only a few years' schooling. First he sold belts and lighters in Tiananmen Square. When that was banned, he joined some friends from back home in Beijing's Silk Market, where he sold vegetables and silk items to the staff of the embassies nearby.

The Silk Market is famous for selling brand-name goods at suspiciously low prices, often to tourists who seem to enjoy the combination of rip-offs and knock-offs. Fined many times for selling fakes, Mr Zhang eventually decided to change his strategy. He sought a licence to sell genuine goods under the brand

Squeezed 6

China's consumption as % of GDP



Sources: Barclays Capital; *The Economist* *To include undermeasured consumer spending

"Hello Kitty". A white bobtailed cat that first appeared on a purse in the 1970s, Kitty now counts as Asia's answer to Mickey Mouse.

The brand's guardians were initially worried by all the fakes on sale in the market, but in the end they were persuaded that the place was trying to clean itself up. Mr Zhang's business is now doing well. In March he was set to move from his old ten-square-metre stall on the ground floor to a 15-square-metre spot on the third floor, where the market is grouping its more reputable outlets. Most of the other stallholders are also from the countryside, Mr Zhang notes. "I never dreamt that I could one day have a life like this."

Most people think of China as an industrial powerhouse, not a consumer's paradise. Household consumption as a percentage of GDP fell for ten years in a row from 2001. By the end of that decade it amounted to only 34% of GDP, about 19 points below Japan's lowest post-war ratio and 15 points below South Korea's. America's consumption did not dip far below 50% of GDP even during the second world war, as Mr Lardy of the Peterson Institute for International Economics points out in his book, "Sustaining China's Economic Growth". But this declining ratio is deceptive. Consumption in China has actually been growing faster than in any other big country. It is just that China's GDP has been growing even more rapidly.

Consumption always lags income, both on the way up and on the way down, argue Carl Bonham of the University of Hawaii at Manoa and Calla Wiemer of the University of Southern California. This is partly because people choose to "smooth" their consumption over time, but also because people generally hesitate to abandon a lifestyle to which they have grown accustomed. Although China's output and income surged after 2000, its consumption habits have yet to catch up.

Bootstrap businessmen from the boondocks do not always know what to do with their newfound wealth, according to research by Jacqueline Elfick, a cultural anthropologist. One couple, newly arrived in Shenzhen, lined their entire flat with bathroom tiles. Another complained that their bathroom windows lacked the blue translucent glass found in rural toilet blocks. A homebuyer who had never previously lived in anything bigger than a two-room flat took a residence with six rooms, filling four of them with dining suites.

But consumer habits are evolving. In Shenzhen, notes Ms Elfick, the constant churn of the population and relative absence of established hierarchies means "you are what you buy." The new rich announce themselves by spending profusely. They favour "heavy ornate furniture in faux Baroque". In Sanya, an advert for one luxury residence shows a painting of Napoleon crossing the Alps hanging on the wall as a woman in a low-backed evening dress lingers by the window.

But there is also a growing class of discerning customers who look down on ostentation. They pride themselves on their appreciation of wine, tea and coffee. In Beijing the TV screens that now pop up in taxis teach passengers how to judge a wine's intensity and why they should not overfill their glass. "Knowledge of how to consume has in itself become a commodity," Ms Elfick writes.

Just as consumption failed to grow as quickly as incomes over the past decade, it will fail to slow as quickly over the decade to come. As China's growth eases from 10% a year to something closer to 7% during this decade, consumption will rise naturally as a share of GDP.

Some economists think it has already begun to do so. Yiping Huang of Barclays Capital says the official statistics fail to reflect a surge in consumer spending since 2008. They are particularly bad at capturing extra spending on accommodation, such as rent payments by tenants or the benefits enjoyed by owner-occupiers.

One proxy for consumer spending is retail sales, which have grown much faster than GDP in recent years. Unfortunately, these statistics are no better at capturing expenditure on accommodation. And in China they include many things other than household consumption, such as government purchases and trade in industrial products like basic chemicals. But even when those items are stripped out, Mr Huang shows, sales are rising fast.

He thinks that the level of expenditure as well as its growth may be understated. Despite the conspicuous consumption, a lot of income and spending is hidden from the prying eyes of taxmen and statisticians. The best effort to throw light on this shadow income is a study by Wang Xialou of the National Economic Research Institute at the China Reform Foundation. His team asked about 4,000 of their friends how much they earned and spent. The answers they got were more candid, though also less representative, than official surveys. After doing some statistical tricks to eliminate the bias, Mr Wang calculated that the disposable income of China's households was 9.3 trillion yuan ($1.4 trillion) higher than the official 2008 figure of 14 trillion yuan. Drawing on this work, Mr Huang thinks that private consumption may have accounted for 41% of GDP in 2010, about seven points higher than the official figure (see chart 6, previous page).

Mr Huang's calculations do not convince everybody, and even if they are right, they have disturbing implications. Hidden income disproportionately benefits the better-off: the richest 10% of urban households take home over 60% of it. That might help explain why China is now the world's largest market for luxury goods, according to one estimate. If that hidden income is counted, the top tenth of urban families are about 26 times better off than the bottom tenth, not just nine times, as the official figures suggest. These figures make China's economic imbalances look better but its social inequities far worse.

However, there is another important source of final demand that is often neglected: the government. Its consumption spending (on health care, education, subsidised rent and so on) as a share of GDP has been growing since 2009, but it remains inadequate and uneven.

The patchwork state

China has greatly broadened its rural pension scheme, which collected contributions from 140m people in 2011, compared with under 80m a year before. But even now it reaches only about 30% of the eligible population. The government has also expanded the coverage of health insurance, bringing 95% of the population into the net, according to the OECD. Patients now pay directly for only 35% of China's total health spending, compared with well over 60% ten years ago. But progress has not been uniform. China has one scheme for urban workers, another for non-workers and a third for rural folk, each administered by separate city or county governments. The contributions required and benefits provided differ a lot between the three schemes. According to the OECD, the rural scheme pays out an average of only $16 per person per year and covers only 41% of the cost of in-patient care.

An important source of demand

In social as in economic policy, the government prefers local experimentation and piecemeal expansion. That works well for economic reforms, but in social policy it fails to pool risk efficiently. And the safety net is thin as well as patchy. This keeps down its cost to the exchequer but leaves the population exposed to dangers such as debilitating illness or job loss. Health benefits, for example, are capped, leaving patients uncovered for the worst crises. And China's hospital-centric health-care system provides only one general practitioner for every 22,000 people.

Older Chinese grew up in a society where many of their consumption choices were dictated by the state or by their workplace. They ate in state canteens and slept in state-provided dormitories or flats. It was a grinding, tedious existence. But in discarding the "iron rice bowl", the Chinese state failed to provide alternatives, including health care and minimum pensions. According to the World Bank, China spends only 5.7% of its GDP on these items and other forms of social protection, such as payments to support the very poor. Other countries in the same income category as China spend more than twice as much, an average of 12.3%.

More social spending of the right kind would not crowd out private consumption. On the contrary, it would encourage it. The patchiness of China's safety net is one reason why households save so much of their incomes. According to Emanuele Baldacci and other economists at the IMF, a sustained rise in public spending by 1% of GDP, spread evenly across health, education and pensions, would increase the ratio of household consumption to GDP by 1.25 percentage points. The IMF's Steven Barnett and Ray Brooks calculate that in urban areas every extra yuan the government spends on health prompts an extra two yuan of consumer spending.

Can China afford to spend so freely? In one sense, it cannot afford not to. If investment were to falter and private consumption failed to compensate, China would be left with a big hole in demand, jeopardising employment and growth. If the investment rate were to drop back to its 2007 level, for example, the demand shortfall would run to over 6% of GDP. To make up for that, the government would have to spend about 3.4 trillion yuan this year, or face widespread joblessness. That is a substantial amount. With only a sixth of that sum, the government could raise the incomes of all of China's poor to the equivalent of $2 a day, according to calculations by Dwight Perkins of Harvard. The point of such a thought experiment is to demonstrate that China has enormous productive powers to mobilise, and has to spend a lot to mobilise them fully.

There is another obvious measure, peculiar to China, that would lift consumer spending. That is the earliest possible repeal of the country's household registration system, or *hukou*, which limits the access of rural migrants to public services in the cities where they work and live. This keeps migrants unsettled and therefore unwilling to spend. Migrants without an urban *hukou* spend 30% less than otherwise similar urban residents, according to research by Binkai Chen of the Central University of Finance and Economics, Ming Lu of Fudan University and Ninghua Zhong of Hong Kong University of Science and Technology.

Mr Zhang, the Silk Market trader, is a good example of the system's iniquity. He arrived in Beijing 17 years ago. He has a house, a son, a business and even a licence from Hello Kitty. But he still does not have a Beijing *hukou*. ■

The next chapter

Beyond growth

China will have to learn to use its resources more judiciously

THE POLICYMAKERS WHO will determine China's future are trained at the Central Party School, a spacious oasis of scholarly tranquillity in north-west Beijing. The campus looks like an Ivy League school with Chinese characteristics. The grounds are dotted with stiff bamboo as well as pendulous willows, pagodas as well as ducks. The school remains largely closed to outsiders. In the past it did not even appear on maps. But it is opening up. The campus signpost, for example, is sponsored by Peugeot Citroën.

The school has over 1,500 students and almost as many professors, many of whom are much younger than their students. It teaches economics, public finance and human-resource management as well as communist doctrine, such as Marx's labour theory of value. It takes only three or four classes to teach Deng Xiaoping Theory, the party dogma that legitimised China's economic reforms and still guides its Politburo. But if even that is too much, three famous clauses may suffice: "Our country must develop. If we do not develop then we will be bullied. Development is the only hard truth."

Deng said these words 20 years ago, not at a portentous party conference in Beijing but on his "southern tour" of the workshops of the Pearl River Delta. He was inspired by practice, not theory, having just visited a refrigerator factory in the delta that had expanded 16-fold in seven years. Even the word he used for truth (*daoli*, which is often translated as reason or rule) is more colloquial than the loftier term, *zhenli*, reserved for high truths like Marxism-Leninism.

Giants playing catch-up

Thanks to a sevenfold rise in its output since then, China is well past the point of being bullied. Its dollar GDP, measured at purchasing-power parity, may have already overtaken America's, according to economists such as Hu Angang of Tsinghua University or Arvind Subramanian of the Peterson Institute for International Economics. Converted at market exchange rates, it is still much smaller than America's. But even by that measure, China may catch up sooner than many people currently expect. To draw level with America by 2020, China's dollar GDP would have to grow at only about three-quarters of the average rate it recorded over the past decade.

"Our country must develop. If we do not develop then we will be bullied. Development is the only hard truth"

Now that China has become too important to be bullied, development may be less of an imperative. Indeed, in some quarters of society there is an increasing distaste for the unwelcome side-effects of China's growth model, which depletes the country's natural assets at the same time as it expands its physical ones, and which builds lots of property but often bulldozes property rights.

Some party elites and vested interests may also have grown complacent, worrying more about how to divide the economic spoils than how to enlarge them. But at least in their rhetoric, leaders do not appear to be resting on their laurels. Asked about China's prospects of becoming the world's number one economy, Li Wei, head of the Development Research Centre, which advises China's cabinet, saw no reason to celebrate. The country's income per person still ranks around number 90 in the world. And even if its GDP overtakes America's by the end of the decade, China will remain as poor as Brazil or Poland are today, by one estimate.

Hubris may be less of a danger than its opposite, a kind of economic diffidence. If China is still poor in the minds of policymakers, they may conclude that the economy is not yet ready for reforms that are in fact overdue. They may feel that a poor developing country does not need a more sophisticated financial system, cannot cope with a more flexible exchange rate and cannot afford to let its rural masses settle in the cities with their families.

As long as the demand for investment remains strong and the supply of saving captive, China's policymakers can feel confident that their country's economy will continue to enjoy rapid growth and stability. But the faster that China expands, the sooner it will outgrow the development model that has served it so well for so long. Japan began to change its growth model back in the mid-1970s. By some measures China has already reached a similar stage of development, and yet its reforms remain tardy and timid.

School rules

There are at least three schools of thought on China's economic prospects over the next few years. The first sees few dangers ahead. China has expanded quickly, always beating forecasts, and will continue to do so for the time being. It is a huge, fast-developing country with plenty of room yet to grow. It invests a lot—and so it should. These investments might not always generate good returns for the bankers that lent the money. But they will contribute more to the economy than they cost.

The second school of thought argues that China's imbalances could overwhelm it. It cannot sustain its current high rate of investment, but there is nothing else to replace this as a source of demand. Much of the credit extended by banks and shadow banks to keep growth going will sour. A government that owes its legitimacy entirely to growth will find it hard to contain the disappointment that a slowdown will entail.

This special report subscribes to a third school of thought. It argues that China does face significant problems, but nothing it cannot handle. It has not obviously overinvested, but it has often invested unwisely. That is imposing real losses on Chinese developers, depositors and taxpayers. However, China's financial system is better equipped than many others to ride out these losses. It may be inefficient in its allocation of capital, but it is quite stable. Indeed, it is resilient for some of the same reasons that it is inefficient.

Until recently most economists believed that China was heavily dependent on exports. But it has carried on growing even as its current-account surplus has shrunk, and trade has subtracted from growth, not added to it. The country is undoubtedly investment-dependent, but its biggest problem is malinvestment not overinvestment. Most people believe that its past malinvestment will impede future growth. This special report has raised doubts about that. Clearly China would be better off had it not wasted so much capital. But if the capital stock is not as good as it should be, that gives the country all the more room for improvement.

If the investment rate does fall, China will need another source of demand. The obvious place to look is household consumption, but consumers may not rise to the challenge. This special report has argued that a much higher rate of government consumption would be equally desirable—and perhaps more feasible.

As China's capital accumulates, its population ages and its villages empty, saving will grow less abundant and good investment opportunities will become scarcer. China will then need to use its resources more judiciously. That will require it to free up its financial system, introducing more efficiency even at some cost to stability.

China is a vastly more prosperous and expansive country than it was 20 years ago. It has broader horizons and can afford a wider range of concerns. Development is no longer China's only truth. But it is still hard. ■

Still plenty of room to grow