Squaring the Circle: How China Can Combine Growth with Deleveraging

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China pushes into 2016 facing multiple challenges. Supply side reforms and shrinking exports threaten to throw growth and employment off course. A torrid expansion of lending has added to financial risks and raised larger concerns about the medium-term growth path. The People’s Bank of China (PBOC), China’s central bank, has stabilized the yuan but the larger goal of a more market-set exchange rate has receded farther into the distance.

To address these challenges, this policy memorandum proposes action across three fronts:

First, a fiscal stimulus targeted at expanding public services and raising the spending power of China’s low-income households would provide a boost to growth and employment but without the downsides of another credit-fueled splurge.

Second, a step change in transparency would enable China’s financial markets to operate more efficiently. By channeling more funds to high return private and services sector firms, the Chinese financial system could generate more output bang for less credit buck.

Third, steps that revive faith in China’s short- and medium-term growth prospects, combined with greater transparency of both economic data and policy thinking, would boost confidence, creating the conditions for the PBOC to move toward a more market-determined exchange rate.

The memo looks at each of these measures in turn, concluding with some more granular recommendations that flow from these three arguments.
In the past, Chinese monetary policy has always done the bulk of the work to support growth. And while this has been effective, it has come at a cost. Bank assets have tripled since 2008 and non-performing loans at 1.3 trillion yuan ($200 billion) are now equal to 2 percent of China’s GDP. Businesses and local governments in China carry a heavy burden of debt. Repayment has been made more difficult as overcapacity has dented prices and profits.

Even if there were an appetite for a major monetary stimulus at this point, the space to do so is limited. Deposit rates at 1.5 percent mean there is not much space to cut before banks’ net interest margins are eroded. A cut in rates would also open a wider interest rate differential with the United States and add to downward pressure on the yuan, something the PBOC may be keen to avoid in the immediate future.

This does not, to be sure, mean that there is no scope for monetary support. The PBOC is already making stealth moves to guide market rates lower and encourage more lending to small and medium-sized enterprises. It does mean, however, that more of the heavy lifting on any stimulus will have to be done elsewhere.

And that should focus attention squarely on fiscal policy.

Figure 1. Low Government Debt as % of GDP

Source: Bloomberg.
China’s government debt-to-GDP ratio is just 43 percent according to the International Monetary Fund (IMF), low when compared internationally.\(^2\) Even if that figure does not take account of all of the Chinese government’s liabilities, a manageable debt level still means there is scope to leverage the public sector balance sheet (see Figure 1).

Indeed, public spending is already playing an expanded role in bolstering demand, having accelerated to 20 percent annual growth in the final quarter of 2015.\(^3\) Premier Li Keqiang’s 2016 work report promised to expand the fiscal deficit to 3 percent of GDP in 2016, up from 2.3 percent in 2015.\(^4\) A fiscal stimulus focused on expanding social services and raising the spending power of low-income households would deliver a significant boost to growth in the short term. By accelerating gains in household income, it would also add impetus to the economic rebalancing agenda.

The most immediate impact would come from directly increasing public spending. In the past, the focus of fiscal stimulus has been roads, rails, and power plants. Shifting the focus by increasing spending on education, healthcare, and other social services would deliver a similar boost to growth but also support robust employment, raise incomes, and expand the role of the services sector.

In general, fiscal multipliers should be larger in countries with multiple market failures, low debt, and weak private sector credit demand. China meets all of these tests and the academic literature is in broad agreement that the fiscal multiplier is large. Writing in 2013, for example, Xin Wang and Yi Wen of Tsinghua University and the Federal Reserve Bank of St. Louis estimate that the fiscal multiplier is above 2.\(^5\) Wenhui Ye and Dongwei Lou, in a paper published by a think tank under China’s Ministry of Finance, estimate that from 2004 to 2010 it was 1.4.\(^6\) An early attempt to model the impact of China’s mammoth 2009 stimulus, by Dong He, Zhiwei Zhang, and Wenlang Zhang put the multiplier at 1.1.\(^7\)

Picking a number in the middle of that range—and this would be conservative, given that the recent slump in credit demand should have reduced any drag from crowding out private investment—we assume that the fiscal multiplier is 1.5. That means a 1 percent of GDP increase in the fiscal deficit would result in a 1.5 percent expansion in China’s GDP. If the majority of the expansion served to increase capacity in public services, the extra spending could create up to 10 million new jobs. This calculation of additional jobs is based on the breakdown in the share of additional output between services and manufacturing and the labor intensity of output in each of those sectors.
There are, of course, shortcomings to that approach. An increase in capital spending on schools and hospitals would have the biggest short-term positive impact on growth and expand capacity to provide public services in the future. But the immediate impact of extra spending would once again be channeled into construction.

Still, an increase in spending on nurses and teachers would not deliver the same immediate benefit to growth. And without a supply side response, it would also risk being lost in higher wages without improving services. The risk of a wider inflationary impact is low, given China’s falling prices and significant slack in the economy.

Given all these challenges, an alternative approach is to target deficit spending toward increasing household incomes.

Cutting income taxes, or replicating policies employed in the United Kingdom and elsewhere with negative tax rates for low earners, would directly raise household income. The problem with this approach is that with household savings rates high, a portion of the increase in income will be saved, reducing the stimulus’ bang for the government’s deficit-spending buck.

Based on average household savings rates for urban households, the multiplier for stimulus targeted at raising household incomes could be just 0.7 (see Figure 2). Deficit spending of 1 percent of GDP would generate additional output equivalent to 0.7 percent of GDP.

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**Figure 2. Impact of a Fiscal Stimulus Equivalent to 1% of GDP**

- Expanding public services
- Raising household income
- Raising low-income household income

Source: Bloomberg.
The effectiveness of a household-income focused fiscal stimulus could be enhanced if it was targeted at low-income households. Contrary to the popular myth of China’s “thrifty poor” driving high national saving rates, it is actually the richest households that are doing most of the saving. Low-income households have a higher propensity to consume. That means a fiscal stimulus targeted at raising the income of the bottom 40 percent of households would likely have a slightly higher multiplier—about 0.8, based on National Bureau of Statistics (NBS) data for urban households (see Figure 3). And that data does not include migrant households, which have an even lower income and higher propensity to consume. That means, in turn, that 0.8 is a conservative assumption.

A 1 percent of GDP fiscal stimulus targeted at raising incomes for the poorest 40 percent of households would boost GDP by 0.8 percent, of which about half would come from additional service-sector output, creating more than 4.5 million new jobs.

A hybrid approach of a 0.5 percent of GDP stimulus to expand public services and the same amount to raise incomes for low-income households would have a result in between these two extremes. GDP would expand 1.1 percent, with most of that coming from an expanded services sector and as many as 7 million new jobs created.

In theory, there are reasons for caution on the effectiveness of any fiscal stimulus. Ricardian equivalence—

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**Figure 3. Low Income Households Have Lower Saving Rate**

Source: Bloomberg.
named for the 19th century English economist David Ricardo—suggests that if households see higher public spending today, they will expect it to be paid for with higher taxes tomorrow. If they respond with higher savings, then the impact of the stimulus would be lessened.

But whether or not that theory holds in the real world is an issue that economists hotly debate. China’s recent history is littered with examples of short-sighted behavior by households—most recently, the rush to invest in China’s bubbly stock market.

Even leaving these concerns aside, and assuming that China’s households are rational and forward looking enough to fit Ricardian theory, there is still reason to believe a properly targeted fiscal stimulus could be effective.

The hope would be that a targeted increase in deficit spending could catalyze a virtuous circle of rising incomes, higher demand for services, job creation, and a further rise in incomes. A boost to households’ confidence in their future earnings could offset any concerns about future increases in taxes.
For the last seven years, China’s credit expansion has outpaced growth in the real economy, often by a considerable margin. An acceleration of lending that started as a legitimate response to the global financial crisis has developed its own momentum.

The consequences, both for China’s financial system and its real economy, have been far reaching. Economy-wide debt rose to about 250 percent of GDP in 2015, up from 160 percent in 2008 (see Figure 4). Assuming an average 10-year maturity on borrowing, and all loans priced at 5 percent (just above the benchmark), the cost of repaying principal and interest is already 37.5 percent of GDP.

On the current trajectory, by 2020 outstanding credit could be 310 percent of GDP and the cost of debt servicing will push close to 50 percent of total output. That, more than anything, lies at the root of foreign investor angst about China’s medium-term outlook. After all, if more and more credit is required to drive less and less growth, sooner or later the outcome cannot be good.

And instances of financial stress in China are on the rise. Bloomberg Intelligence Economics maintains a database that captures news reports of defaults by borrowers in the bond markets, wealth-management products that have gone bad, and other signs of strain (see Figure 5). In 2015, there were 38 reported

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**Figure 4. Debt to GDP Level Rising Fast**

![Graph showing the debt to GDP level rising fast, with data from 2007 to 2015.](image)
cases, ranging from a missed payment on a 26 million yuan ($4 million) loan by a Hainan real estate developer to the case of Fanya Metal Exchange, where investors protested the freezing of more than 40 billion yuan ($6.1 billion) in funds and 16 arrests were made.\textsuperscript{11} Those 38 cases represent a marked increase from 12 in 2014, three in 2013, and just one in 2012. So far in 2016, Shanshui Cement has missed payment on a 1.8 billion yuan ($280 million) bond.\textsuperscript{12} Ezubo—a peer-to-peer lending scheme—has allegedly defrauded investors of close to 50 billion yuan ($7.7 billion), drawing comparisons with US financial con man Bernie Madoff.\textsuperscript{13}

There is, in one sense, a positive aspect to the rise of defaults in China’s financial system: without defaults, moral hazard abounds, risk is not priced appropriately, and the financial system cannot perform its core job of allocating funds efficiently. But even so, the rise in instances of financial stress in China is striking. It speaks to the potential for more serious problems if credit continues to expand ahead of the ability to repay.

Looking at the headline credit data and reading the steady trickle of negative stories in the financial press, some investors have concluded that China is caught in a debt trap from which it will be difficult to escape. In our judgment, that degree of pessimism is a mistake, for several reasons:

- China’s borrowing is almost entirely domestic. Foreign borrowing at $856 billion as of the third quarter

Figure 5. Reported Cases of Financial Stress on the Rise

Source: Bloomberg Intelligence.
2015 accounted for just a few percent of total outstanding credit.\textsuperscript{14} Even if all foreign lenders pulled out their funds, the impact on China’s financial system would be limited. That is a sharp contrast with the situation faced by South Korea in the Asian financial crisis or Greece in the European sovereign debt crisis, when the exit of foreign lenders had a catastrophic impact.

- China’s banks have a stable funding base. For China’s 16 publicly traded banks—a list that includes giants like Industrial and Commercial Bank of China (ICBC), as well as smaller banks like Shanghai Pudong Development Bank—deposits account for more than three-quarters of liabilities.\textsuperscript{15} That stands in sharp contrast with Lehman Brothers and the US investment banks that tottered in 2008. They relied for funds on the overnight money market, which meant they were vulnerable to sudden reversals in confidence.

- On the borrowers’ side, leverage ratios remain under control. In the industrial sector as a whole, in the last 10 years, total liabilities held steady at about 135 percent of owners’ equity.\textsuperscript{16} That suggests, in general, that investments were productive, generating profits that have replenished equity.

It also suggests that firms have a substantial buffer to guard against the risk of bad loans and bankruptcy.\textsuperscript{17} Taken together, these factors mean that there are few immediate triggers for crisis, so China’s policy makers have time on their side. But managing down credit expansion without dealing a substantial blow to the real economy, or precipitating the very financial instability that deleveraging is meant to avoid, will be a considerable challenge.

The solution has to be multifaceted. The PBOC has already made important strides toward the liberalization of interest rates and the expansion of direct finance through the bond market. Aggressively implemented, the government’s supply side reform agenda—a priority for 2016—could help to strip away moral hazard by removing the implicit no-default guarantee from state-owned borrowers.

The missing piece of the puzzle, then, is transparency.

By enabling investors to channel funds toward high-growth success stories and away from low-potential “lemons,” better information can catalyze more efficient credit allocation.

The wide difference between return on assets for firms in China’s new and old economy illustrates the potential for progress if that begins to happen. The ratio of gross profits to assets for
private firms was about 18 percent in 2014. For state-owned enterprises, it was 11 percent. The ratio for steel firms averaged just 7 percent. For production of automobiles, it was 19 percent.\(^1\)

This means there is considerable scope to reduce the credit intensity of growth—if better information enables investors to channel more credit to sectors with higher returns.

In 2016, Premier Li Keqiang is targeting a 13 percent increase in aggregate finance, implying some 17.9 trillion yuan ($2.8 trillion) in new lending. China’s debt to GDP ratio, and the burden of servicing that debt, is set to rise again.

An increase in the efficiency of lending would enable a smaller amount of new credit to do the same amount of work in supporting growth, helping to bring debt onto a more sustainable trajectory.
Concern about China’s short- and medium-term growth prospects has affected investor sentiment and complicated PBOC efforts to take the final steps to liberalize China’s exchange rate. The central bank moved in August 2015 to correct the mismatch between the yuan’s central parity and spot price, shift focus away from the yuan-dollar cross and toward the trade-weighted exchange rate, and give the market greater influence. But these moves were widely interpreted by bearish international investors as the first step in a competitive devaluation. As a result, the PBOC was forced to wade back into the market, expending foreign exchange reserves to prevent a disorderly drop in the yuan.

China’s policymakers have now succeeded in stabilizing the currency, but the larger goal of shifting toward a more market-set exchange rate—a critical building block of China’s reform process—has receded farther into the distance.

How can China create the conditions for a shift from the current environment of exchange rate stress and central bank intervention to a managed float?

A targeted fiscal stimulus and an increase in transparency could help quite a lot. Here are some reasons why:

First, of 15 countries that exited from pegged exchange rates in the period

Figure 6. Exits from Exchange Rate Pegs Easier When Growth Is Strong

Source: Bloomberg.
since 2000, only those with rising growth enjoyed a stable currency (see Figure 6). That means that if China wants to stabilize expectations on its exchange rate, it needs to restore confidence in growth. An old fashioned monetary splurge would boost growth in the short term. But by adding to the problem of leverage it would make China’s longer-term challenges more difficult to address. As Japan has found to its cost in the age of “Abenomics,” major problems on the medium-term horizon mean that even an aggressive stimulus can fail to shift fundamental negative perceptions. A fiscal stimulus focused on service sectors and low-income households, by contrast, would bolster confidence in China’s short- and long-term prospects.

Second, there is a widespread view in the markets that China’s GDP data overstates the actual growth rate. An informal poll of several economists conducted by Bloomberg Intelligence Economics found estimates of the “true” growth rate in the third quarter of 2015 ranging from 3.1 to 6.4 percent, with even the top of the range quite a bit below the official 6.9 percent growth rate. Against this backdrop, the PBOC’s August move was interpreted by many market participants not as a technical correction in the yuan fixing but as confirmation that the markets’ pessimistic views on growth were correct and the central bank was, quite simply, beginning a desperate stimulus attempt.

More granular, high frequency growth data, with greater transparency on its methodology, would remove some of the mistrust in China’s official numbers, providing a more supportive atmosphere for the central bank to manage the delicate transition to a managed float.

Third, lack of communication by the PBOC in the period immediately after the August move was an additional factor that added to confusion. Communication improved considerably in the months that followed. But there remains a lack of clarity over key questions, including which basket of currencies the PBOC references in setting the exchange rate.
Some Recommendations

This analysis suggests three broad areas for action:

Building on the commitment to a more active fiscal policy at the March 2016 National People’s Congress, China’s Ministry of Finance should focus an expanded stimulus on enhancing public services and raising incomes for low income households. An aspirational macroeconomic policy package would include aggressive supply side reforms to reduce inefficiency in the state sector of the economy, an expanded and targeted fiscal stimulus to offset the drag on demand from bankruptcies in traditional industries, and a neutral monetary policy to avoid exacerbating stresses from overdone credit.

To build confidence in the official data, NBS should aim to publish sufficient granularity of data and transparency on methodology so that independent analysts can replicate the official GDP series. Comprehensive, detailed and regular reporting on local government finances would enable a market driven solution to the problem of provincial debt.

Corporations, too, should be held to high reporting standards, with a presumption in favor of access to information for investors, analysts, and the media.

Some of the conditions for shifting toward a managed float exchange rate are outside of the control of the PBOC. But some are not. These include addressing concerns about credit risks, data transparency on the financial system, and communication of policy. The PBOC should set out a clear plan for stabilizing the growth of credit, increase the granularity of data on the financial system and cross border capital flows, and establish regular channels for communication of policy, moving away from irregular press conferences.
Endnotes


2 International Monetary Fund (IMF), World Economic Outlook, accessed at www.imf.org.


9 Ibid.


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