Some things to watch for in 2018: Part One

Special points to highlight in this issue:

- Because China still has debt capacity, GDP growth in 2018 will be broadly equal to whatever Beijing sets as its GDP growth target. It is extremely unlikely, however, that Beijing will set the target at anywhere close to the level that allows regulators to regain control of runaway credit growth.
- Because growing public sector infrastructure investment is required to help China achieve any GDP growth target it chooses above roughly 3 percent, we can expect that public sector infrastructure investment will continue to rise as a share of total Chinese domestic demand.
- Household income growth outpaced GDP growth in 2017 by 0.7 percentage points. This represents some rebalancing, of course, but at this rate it will take China 25-30 years to achieve even the lowest acceptable rebalancing of domestic demand.
- As GDP growth continues to slow, we are likely to see local governments react in ways that interfere with the efficiency of monetary management. Given extremely high debt levels, this is likely materially to impact growth prospects in a self-reinforcing way.
- For all the discussion about enforcing market discipline by eliminating explicit or implicit government guarantees on local-government and corporate borrowings, any credible reintroduction of credit risk is likely to cause an unacceptably large and disorderly pricing adjustment.
I would like to wish my readers a very good 2018 but, to tell the truth, I am pretty mixed about the prospects for the year. On the surface, I think 2018 might be seen in many ways as a reasonably good year. Reported growth prospects in China seem solid, but behind the numbers there are likely to be unflattering trends.

It is pretty clear, for example, that Beijing is very worried about the growth in debt and would like to rein it in, but I am concerned about the level of sophistication within the leadership when it comes to understanding the relationship between credit growth and GDP growth. Although Beijing has taken steps to de-emphasize GDP growth as the main metric of successful economic policy-making, President Xi and those around him seem more excited about China’s geopolitical prospects than about the need to get credit under control, and concerns over domestic discontent and political factionalism are likely to make it easy to postpone difficult economic decisions.

This is because reducing the debt burden and rebalancing domestic demand both largely entail politically difficult decisions about allocating adjustments costs to local elites. In this kind of environment, the easiest short-term decision is to keep reported GDP growth rates high, and to allow debt to continue to surge.

2018 promises to be such a complex year for the leadership, in other words, that I worry that they will find it too tempting to use toxically high GDP growth rates as a way of minimizing difficult short-term decisions. I hope I am wrong.

During the first five years of Xi’s leadership it was always easy to justify the failure to address the debt burden more aggressively by pointing out how important it was that power was sufficiently recentralized to allow Beijing to implement very difficult economic decisions. But the 19th Party Congress is behind us. It is time now for Beijing to force through the redistribution of wealth from local governments to ordinary households and to pay down debt.

It is all well and good to plan to land a spacecraft on the dark side of the moon, as Beijing recently announced, but if the economy stalls over the next two decades – as has occurred in every single case of an economy that has had a comparable investment-driven growth “miracle” – this will become an increasingly expensive commitment, along with military spending, OBOR, and other such prestige projects, that were previously justified only by expected economic growth rates that turned out to be far too high.

China still has the ability to expand credit further, both within the household sector and, more worryingly, in terms of external debt. I expect rapid credit growth in both sectors as Beijing wrestles with its difficult adjustment, but in 2018 we must begin to see real progress in getting overall debt under control, or if we see no substantial progress, we can increasingly expect Xi’s second term to end badly.

The US needs debt too

China’s geopolitical expansion is sharply contrasted with perceptions of a US withdrawal, but while a gradual US withdrawal over the next several decades from its current level of centrality is all but inevitable (although I suspect by much less than most analysts seem to believe), the idea that US power will be replaced by Chinese power is ludicrous. US commitments to the global system were made at a time when the US represented 40 percent or more of the global economy. Now that it represents roughly 23 percent of the global economy, it has become clear that the cost of US geopolitical dominance is excessive.
China, however, comprises perhaps 15-16 percent of global GDP if we accept reported GDP data as valid, and while there are still a lot of people who are certain that China’s share of the global economy will continue to rise until it surpasses that of the US, they are probably wrong. We are likely simply to see a repeat of the same certainty and its subsequent reversal that existed about the USSR in the 1960s and Japan in the 1980s, and for much the same set of reasons.

While China’s reported GDP may indeed be 15-17 percent of global GDP, this only indicates how useless GDP has become as a measure of anything useful. For reasons I have discussed in previous issues of this newsletter I suspect that China’s real share of global productive capacity is unlikely to be much over 10 percent. GDP in China, unlike for the rest of the world, is a system input, not an output, and it is absurd to treat it the same way.

The real issue for the US, in other words, is not an encroaching China but rather weak domestic demand and a global trading system that places too much of the burden of weak growth abroad on the US. While a US withdrawal from global commitments is likely to strengthen the US economy, and should probably be welcomed, concerns about an encroaching China are misplaced because they understate serious weaknesses in the Chinese economy and overstate the benefits of US global dominance to the US economy.

Meanwhile US income is not as badly distorted as Chinese income largely because of the huge state share of GDP in China, for which there is no US counterpart, but because it nonetheless suffers from some of the highest levels of income inequality in US history, growth in domestic demand will remain sluggish without rising debt, and will continue to be weak until income inequality is resolved. High levels of income inequality put downward pressure on consumption growth. In an environment in which there are huge investment needs that are unmet because of savings constraints, downward pressure on consumption might nonetheless be positive for growth because they allow for higher savings that feed into higher investment.

But as I will discuss in the first topic in this newsletter, we no longer live in a world in which investment demand is constrained by scarce savings, and haven’t for several decades. Income inequality in the US means lower growth because it means lower consumption growth without the counterbalance of higher investment growth. Trade protection will help somewhat, but only temporarily, although if trade protection leads to a better distribution of domestic income – which it often does – the results may be more permanent.

I will return to these topics in future newsletters over the rest of 2018, but for now, there are eight different topics I will discuss, in no particular order, in this and the next issue of the newsletter. I am splitting this issue into two, the second issue to be released next week, because otherwise the newsletter is likely to be too long and fairly cumbersome to read.

-----

1. The global trade regime must be restructured

In October 2016, one year after the renminbi had surpassed the Japanese yen to become the world’s fourth most actively traded currency, the IMF added China’s currency to the four others that comprise the SDR, the international reserve asset created by the IMF in 1969 to supplement official reserves. This seemed to many to confirm the inexorable rise of the renminbi to become one of the world’s two dominant currencies.
A year later, however, in November, SWIFT announced that the share of transactions denominated in renminbi had dropped by nearly half from its previous peak to 1.46 percent. The renminbi had reversed its rise and was knocked back once again to a weak seventh place among the world’s most actively traded currencies.

This should not have been a surprise. As I have often discussed in this newsletter, the renminbi was never going to become a major reserve or trade currency. The fact that its rise was so widely expected, even among economists and central bankers who should have known better, only indicates how confused we are when it comes to understanding the mechanics of international trade and capital flows.

In a world of weak demand, major reserve currency status is in fact an exorbitant burden, not a privilege. Ever since the early 1970s, after the developed world had been substantially rebuilt from the ravages of two world wars, individual countries within the global economy have sought to boost sluggish growth in demand and excess savings by exporting these excess savings and running the corresponding trade surpluses.

 Normally, advanced economies should be net exporters of capital to developing economies, but this hasn’t been the case in recent decades. It has been much easier for economies with excess savings to export capital to those countries with deep and highly flexible capital markets and who impose no restrictions on capital inflows or outflows.

This has mainly meant the US, which typically absorbs nearly half the world’s savings excesses. This is why, contrary to common sense, the world’s most advanced economy has run persistent capital account surpluses, not deficits, for nearly five decades. (It is also why other similarly-structured countries with deep, flexible, and wholly open capital markets, like the UK and Canada, have also suffered from persistently weak current accounts over the same five-decade period). Even today, when investment demand is weak and American corporations are piling up cash hoards which they cannot invest, foreign money continues to pour into the country.

But countries that run capital account surpluses of necessity must run current account deficits because investment in those countries will necessarily exceed savings. A growing gap between investment and savings caused by capital inflows can sometimes be a good thing. In developing countries, including the US 150 years ago, investment is typically constrained by insufficient savings and a lack of access to capital. In that case imported capital results in higher investment, which is positive for growth.

In advanced economies, however, investment isn’t constrained by scarce savings. In that case, because net capital inflows must nonetheless be accommodated by an excess of investment over savings, capital inflows must automatically force down domestic savings.

This may be counterintuitive to many, but it is an unbreakable rule in the international balance of payments.

US savings can be forced down in many different ways, almost always involving either more debt or higher unemployment. For example capital inflows can inflate asset bubbles that encourage spending through wealth effects, or by forcing a corresponding trade deficit that forces up unemployment. Capital inflows can also boost consumption by reducing interest rates on consumer credit, or can encourage weaker consumer lending standards. One way or another, however, in the US and other economies that do not suffer from weak access to capital, foreign capital inflows must automatically force down domestic savings.
This is why the renminbi cannot become a major international currency. With structurally weak domestic demand, China is already overly reliant on debt to generate domestic growth. If foreign investors were to acquire substantial amounts of renminbi assets, China would be forced to absorb a sharp reduction in its trade surplus that could only be accommodated either by a surge in unemployment that forces down savings or by even faster growth in debt to force up non-productive investment.

And this is why Washington is right to take persistent trade deficits seriously and to re-examine the American role in international trade and capital flows. The US, like any country in which investment is not constrained by scarce capital, faces the same trade-off in response to capital inflows. As long as the US is the destination for the world’s excess savings, it too must choose between rising debt and higher unemployment.

Contrary to most discussions, based, as they are on an obsolete model of trade, American deficits have far more to do with the international role of its currency and with the openness of the domestic financial markets than with unfair trading practices in countries like Mexico. That is why the right way to deal with trade distortions is not with tariffs or direct trade intervention but rather to address the impact of distortions in the global capital markets.

Until policymakers in Washington understand why, attempts to redress the US trade imbalances are likely to do more damage than good to the US economy. The same holds true for the Chinese economy, and this is why for all the excited talk emanating from Beijing, the renminbi will not become a major trade currency for the foreseeable future. China may want the prestige that accrues to the dollar, but it has neither the desire nor the ability to bear the exorbitant burden.

If the US begins truly to withdraw from its role as provider of the dominant currency, rather than see a gradual replacement by the renminbi we are far more likely to see a more difficult global trading environment. In next week’s issue of this newsletter I will explain in more detail how US trade action that ignores the capital account might affect the Chinese economy.

-----

2. What will GDP growth be in 2018?

I have many times explained why I think this is mainly a political question, and depends on how quickly Beijing thinks it must rein in credit growth. China still has the debt capacity to achieve a GDP growth target even of 7 percent, and so it is pretty safe to assume that reported GDP growth in 2018 will be whatever Beijing sets as the GDP growth target (or perhaps it will come in just a little lower to make up for coming in higher in 2017). I personally would like to see a 2018 GDP growth target set well below 6 percent, or an abandonment altogether of the practice of setting a GDP growth target, but I suspect that it is too early to do so, and we are likely to see a target set somewhere between 6 and 6.5 percent.

It is by forcing up investment that Beijing will raise China’s GDP growth from its underlying growth rate – probably under 3 percent – to the target GDP growth rate. Growth in total fixed-asset investment (FAI) spending in China decelerated to 7.2 percent nominally in 2017, from just over 8 percent in 2016. In real terms the reduction in FAI growth was even greater, as most measures of inflation rose in 2017, with PPI up nearly 6 percent in 2017, and CPI up by 2 percent. The decline in FAI was driven by slower growth in real-estate development and in manufacturing, and I expect these numbers will not change much in 2018.
Growth in infrastructure investment spending, however, remained very high, at roughly 15 percent. That’s just another way of saying that government-led investment is accounting for an increasing share of China’s continued ability to meet the GDP growth target. If Beijing insists on a GDP growth target above 5 percent in 2018, as I expect, this trend cannot help but continue: infrastructure spending will further increase its share of overall fixed-asset investment as the government increases its role in driving economic growth. This will be even more true if, as many expect, we don’t see as strong a property cycle in 2018 as we saw in 2017.

Credit growth slowed moderately during the first eleven months of 2017 to just over 14 percent from nearly 16 percent in 2016, which is more impressive given the surge in nominal GDP growth, although this does not account for the possibility that part of the reported reduction in credit growth simply consisted of a transfer of credit growth from areas actively monitored and measured by the regulators to non-monitored areas, something that is being referred to as trans-leveraging rather than deleveraging.

For example, Andrew Collier of Orient Capital estimates that 80 percent of a planned Rmb14 trillion in PPP investments (Private-Public Partnerships) are being securitized and sold to private consumers:

> Recent attempts by Beijing (mainly the PBOC) to restrict shadow loans has forced local governments to devise creative ways of generating capital for investment, along with tax revenue. The latest source of “creative” capital consists of Securitized Private-Public Partnerships. A significant portion of these investments is being removed from bank balance sheets and sold to consumers as investment “products.”

It is not clear exactly how these PPP loans will be treated, but most of these loans are unlikely to show up in the Total Social Financing data, which is the most widely used measure of credit growth in China. This means that even though they represent real growth in overall debt, PPP-related debt is unlikely to show up in most of the most common measures of Chinese debt levels.

But even ignoring the very high likelihood of trans-leveraging, China’s debt burden in fact continued to deteriorate in 2017. The amount of additional credit issued in each period, when measured as a share of that period’s GDP, continued to accelerate in 2017 even if we limit our measures to the official data. It took an increase in debt of roughly 45-50 percentage points of GDP in 2017 for China to achieve its GDP growth target.

There is no question that Beijing is taking the growth in credit seriously and is worried about it, and the need to rein it in is going to be the biggest constraint for Beijing on keeping the GDP growth target high. My guess, however, is that there is still a residual sense in Beijing that there are ways of getting credit growth under control without significantly sacrificing GDP growth. I expect – or perhaps only hope – that by this summer that residual sense will have evaporated. We can only wait and see.

-------

3. Is China rebalancing demand within the economy?

According to the World Bank, real household income grew by 7.5 percent in the first three quarters of 2017, compared to 6.8 percent in GDP. This represents a partial rebalancing of income towards the household sector, but not by much. At the current spread between the growth in household income and the growth in GDP, it will take 25-30 years for households to increase their share of GDP by ten percentage points.
I would argue that China must raise the share by at least that much – preferably much more, perhaps by 15-20 percentage points – if it is to rebalance the economy to the point where it is not overly dependent on trade surpluses and domestic investment to generate growth. Unfortunately, China doesn’t have 25-30 years in which to do this. I doubt if it even has ten years.

It is easy enough to do the relevant calculations. For the household income share of GDP to rise by ten percentage points in ten years requires that household income grow by 2 percentage points faster than GDP during this period. The amount of higher growth in household income relative to the growth in GDP, in other words, must nearly triple for it to be credible.

During the first three quarters of 2016, consumption accounted for 4.5 of the 6.8 percentage points of GDP growth, which is substantially more than it has in the past, but it is strange that so many analysts trumpet this fact as proof that China has put the problem of rebalancing behind it. The rising consumption share of GDP over the past decade mainly reflects the fact that GDP growth has declined so much during this period.

There is nothing wonderful about this, and the process will continue fairly automatically. Eventually growth in consumption will explain roughly 100 percent of growth in GDP as investment growth drops to close to zero and GDP growth drops to 3 percent or thereabouts. This is just arithmetic.

**Chinese rebalancing faces headwinds**

But while rebalancing must speed up substantially, to nearly three times the current rate, it is not clear that the rebalancing process will improve much in 2018. We saw a huge rebound in Chinese industrial profits in 2017, with profits up between 20 and 25 percent, after much lower growth in 2016 and negative growth in 2015. I don’t usually pay much attention to industrial profits, but if such rapid growth continues in 2018 I would be concerned about the impact on China’s rebalancing.

Given the various controls and subsidies in place, especially on interest rates, one way of thinking about industrial profits is in terms of transfers among the household, business and government sectors of the economy. For China to rebalance demand sustainably towards consumption, it is necessary that the household share of GDP rise as quickly as possible, which probably requires that increases in industrial revenues translate more into higher wages than higher profits. Industrial revenues grew at only half the pace of industrial profits, however, suggesting that businesses are gaining at the expense of households. Without a very strong decline in the government share of GDP, for which I see little evidence as of yet, it is hard not to see this as bad for China’s rebalancing.

Also bad for rebalancing has been the surge in the various forms of inflation in China relative to interest rates. While real GDP growth rose modestly in 2017 relative to 2016, nominal growth surged, with the GDP deflator surging from negative to above 4 percent. The benchmark lending rate, however, has stayed constant over the past two years at 4.35 percent, with the benchmark deposit rate also unchanged at 1.50 percent.

This means that households are facing a renewed inflation tax on their savings, proportional to the gap between nominal GDP growth and the deposit rate. Part of this tax goes to subsidize bank profitability, and part to subsidize corporate and government borrowers. This “tax” hasn’t been as substantial as it was a few years ago partly because, in the past five years, household debt has risen from roughly 20 percent of GDP to nearly
50 percent, which means that household as borrowers benefit from artificially low interest rates in the opposite way that households as savers suffer. But given a high household net stock of savings, it still represents a substantial flow from the household sector to borrowers, which are mainly the business and government sectors.

If we see a sharp reduction in PPI inflation in 2018, this should drive down both the growth in industrial profits and the inflation tax on savings, but if not, only a sharp and unlikely rise in interest rates will prevent these from slowing and possibly even reversing the little bit of rebalancing we have experienced after 2012 from investment to consumption as sources of demand. By definition, the more unbalanced is the distribution of demand, the greater China’s reliance on investment to drive growth, and given that investment continues to be non-productive, and increasingly so, the more rapid the growth in China’s debt burden.

-----

4. Will enforcement of the hukou make it harder for Beijing to manage debt?

Over the past few weeks, people in Beijing have been riveted by the so-called migrant “clean-out” – the government’s attempt to evict tens of thousands of freezing migrant workers from their homes in the poorer parts of the city. What’s not being discussed, however, is how the crackdown could threaten one of the government’s other main priorities: managing debt.

In China, mobility is legally restricted according to a household registration system, called the hukou. Chinese citizens receive an urban or rural hukou which officially identifies them as residents of a specific area and which allows them to live and work only in that area. Few if any of the migrant workers affected by the current sweep possess a Beijing hukou.

This didn't used to matter. For the past three decades, during the period of China’s furious economic growth, the fastest-growing regions were desperate for cheap labor to fill factories and build infrastructure. With local government officials graded in large part on their abilities to generate rapid growth, they largely ignored hukou restrictions and made migration into their cities easy. Hundreds of millions of workers traveled from their hukou areas to wherever there were jobs, in particular big cities such as Beijing, Shenzhen and Shanghai.

The attitudes of local authorities may begin to change as the economy slows and officials become more concerned about unemployment and tensions over access to schools and other social services. One of the easiest tools the authorities have to manage both problems is to enforce the hukou rules that are already on the books. In Beijing, the campaign is broadly popular among legal residents, who complain about overcrowding and rising rents.

China as an optimal currency zone

If it spreads, however, the crackdown could carry a macroeconomic cost. Enforcing the residency system nationally could severely limit labor mobility in China. This would in turn constrain monetary policy, which is critical to minimizing the cost to China of what's likely to be a very difficult adjustment to decades of deeply unbalanced growth.

How exactly? It's important to remember that while China is a huge economy with a great deal of variety across different regions, it can nonetheless operate effectively with a single currency because it has most of the characteristics of an optimum currency area. In the
1960s, Columbia University’s Robert Mundell argued that four conditions were required to establish such an area. They include high levels of labor mobility, high levels of capital mobility, a system of transfers that share risks across the region, and coordinated business cycles.

If labor mobility in China slows dramatically, growth rates in different parts of the country would diverge even more than they have already, rather than converge. As a result, monetary policies aimed at restraining credit growth overall might end up being too tight for some regions, leading to accelerating bankruptcies, and too loose for others, fueling out-of-control credit growth. To prevent financial dislocation in the former, officials would likely tolerate faster credit growth for a longer period of time than they might otherwise. If labor mobility is restricted, in other words, it'll be harder to control the upsurge in debt.

For instance, China’s northeastern province of Liaoning, which suffers from rust-belt industries mired in debt and excess capacity, grew by negative 2.5 percent last year. The ability of the provincial government to continue financing itself was even thrown into question temporarily when one of its largest state-owned enterprises, Dongbei Special Steel, was forced into a messy default. To avoid surging unemployment and rising defaults, Liaoning needs low interest rates and temporarily easy money, but if Beijing wants to restrain credit growth in healthier and faster-growing provinces like Fujian, which grew last year by 8.4 percent, it must do the opposite.

This is already a difficult enough problem, but it would be far more difficult if Liaoning’s unemployed workers couldn’t migrate to where the jobs are, and if provinces like Fujian protected their residents by restricting provincial immigration. Provincial protectionism, after all, is nothing new in China. Less than twenty years ago provinces restricted trade among themselves so severely that one of the main reasons then-Premier Zhu Rongji pushed for China’s entry into the WTO was to use WTO rules to break intra-provincial trade barriers.

Economic consequences of enforcing the hukou

For this reason, authorities should monitor labor practices carefully and take steps to prevent local officials from heavily enforcing the hukou. This may prove difficult, in which case they should consider alternative policies to reinforce monetary integration. They could strengthen fiscal policies that transfer income from faster-growing provinces to slower-growing ones, for example, or manage fiscal spending so that business cycles are more closely coordinated across regions.

One thing we know from the history of developing countries is how suddenly virtuous cycles can become vicious cycles. In China, rapid growth historically encouraged local officials to ignore hukou restrictions. This caused a sharp increase in labor mobility, which made monetary policy more effective and, in turn, encouraged even more rapid growth.

This self-reinforcing process could just as easily reverse itself, with slow growth encouraging officials to restrict labor mobility, weakening the transmission of monetary policy and slowing growth even further. It's already the case that monetary policy isn't transmitted evenly across China; undermining labor mobility will only exacerbate the problem.

We should also note that if Beijing’s mistreatment of migrant workers spreads to other cities, this might have an impact on the ability of internet retail distributors to deliver goods cheaply. One of the bright spots in China’s economy has been the rapid growth of the
internet retail sector, with Chinese households ordering a huge range of products and services over the phone, and expecting delivery within an hour or less.

But the logistics of this process frankly requires very low wages and a lot of unemployed workers waiting in the wings to keep wages low. As a recent article in the Financial Times explains,

“As many delivery people are being cleaned out, it will get more and more difficult to hire,” said Huang Gang, a logistics expert at the China E-commerce Association. “Wages in logistics will increase.”

One courier for SF Express, China’s biggest logistics service, estimated that 20 of its distribution centres — about a 10th of its Beijing total — had been closed. He said six colleagues in his team of 50 had to sleep in their delivery vehicles in temperatures of -5C after their houses were demolished last week. The company has since provided new dormitories to rehouse staff.

If we were to see a sustained crack-down on migrant workers without appropriate hukous, growth in this sector might slow unexpectedly, with a significant impact on the profitability of the internet retail giants. Besides SF Express, companies like JD.com, Alibaba and Baidu may see downward pressure on revenues.

-----

Next week I will release the second part of this newsletter with the next four following topics of discussion:

5. Will Beijing no longer guarantee provincial borrowings?
6. How might trade affect the US and China in 2018?
7. Beware of water shortages and consider their consequences
8. How important is China’s strategic vision for Africa?