DOLLAR & SENSE: THE BROOKINGS TRADE PODCAST

“Checking in on China’s economy during the 20th Party Congress”

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Episode Summary:

Eswar Prasad, a professor at Cornell University and senior fellow at Brookings, discusses China’s economic risks and opportunities with David Dollar as China’s 20th Communist Party Congress continues this week. Prasad and Dollar look at the general shape of China’s economy, it’s housing market, renminbi strength relative to the dollar, and whether President Xi Jinping will continue with a command-led economy that limits independence and innovation among enterprises.

DOLLAR: Hi, I'm David Dollar, host of the Brookings trade podcast Dollar and Sense. Today, we're going to talk about the Chinese economy with Eswar Prasad, an economics professor from Cornell and a senior fellow in the global development wing of Brookings. We're coming to you a little bit later with this episode because the topic naturally involves the 20th party Congress of the Chinese Communist Party, which just started on October 16th. And we wanted to hear Xi Jinping's opening speech before we had our conversation. So welcome to the show, Eswar.

PRASAD: David, always a pleasure to be on your show.

DOLLAR: So, let's start with the general shape of the Chinese economy as this Party Congress starts. I should say Eswar is well-placed to answer this because it produces a real time index of economic activity in major economies, including China, under the brand name TIGER. So what is your sense of the economy and what is the TIGER Index telling us?

PRASAD: So, what the index shows, David, and what most indicators do seem to suggest is that the economy is going through a fairly rough patch. And in the past, I have held that when the Chinese economy gets hit by one or two unfavorable developments, the economy can get past it because usually there is enough policy space.

But right now, we are seeing a raft of indicators that suggest a loss of growth momentum in the economy. And this is on account of a combination of factors. First of all, you have the zero-COVID policy that is severely crimping activity in parts of the economy that have generated good growth in recent years, especially in the services sector.

On top of that, you have a faltering housing market. And housing is, of course, a very important part of the economy and the property sector more broadly, by some estimates, accounts for somewhere between 20 to 30% of GDP, either directly or indirectly. And real estate investment has been an important contributor to Chinese growth in recent years.

And then on top of that, we're beginning to see some of the financial system stresses that have been buried in the economy for a long time beginning to poke their head through. You throw on top of that relatively weak external demand, that makes for rough going.

Now, the additional feature of the particular circumstances that China now faces that is relevant, as said, is the amount of policy space, that is the ability to prop up growth in the short run using fiscal and monetary policy, has become a lot more limited with the depreciation of the yuan relative to the dollar and the fact that you have most of the advanced economy central banks beginning to look to tighten monetary policy. That makes it harder for the People's Bank of China to loosen monetary policy, either through cuts in interest rates or by other measures to spur credit growth, because that could lead to even more capital outflows, more currency depreciation. And the fiscal policy space has also become more limited over time.

So, I think right now, China's short-term growth prospects do look rather bleak. And that's reflected not just in the TIGER Index, but also many of the other forecasts we're beginning to see coming out.

DOLLAR: So, that introduction gives us a pretty good agenda for topics that we can consider in more detail. Let's start with the zero tolerance policy. In a recent survey of U.S.

firms in China, this was actually the number one issue more important than geo strategic tensions. Just the difficulty of people moving in and out of the country and around the country because of zero tolerance. So, as this Party Congress, plays out, are you hopeful that the policy will change? Do you think it's likely that they'll ease up on the zero tolerance, or is this something we're just going to have to live with more or less in perpetuity?

PRASAD: What we are seeing in terms of the Party Congress and especially what Xi Jinping mentioned in his speech, of course, is a sense that the policy has worked well and a seeming reluctance to either change the policy, let alone reverse it significantly. It's hard to see how this is going to be tenable in the longer term, though, because not only is there the fact that it crimps economic activity in cities that are shut down, but it also creates an air of uncertainty, because if you do have a number of cases coming up in any metropolis or even in smaller areas that can very quickly disrupt economic activity. And for businesses, that degree of uncertainty, in addition to the disruptions that they already face, could really be a significant deterrent to further investment and production.

So, it remains to be seen whether once Xi Jinping does consolidate his power, as I expect the end of the Party Congress will indicate, whether he's willing to back off. But certainly in the short term, that is at least in the next couple of months, I don't see any significant change in policy. So, this element, this drag on growth, I think, is going to remain with us for a little while to come.

DOLLAR: Yeah. It seems to me that they become a little bit more flexible in application of the zero tolerance policy. But the uncertainty you mentioned is really critical. I've known a number of international business people who've gone to China, and in some cases they went thinking they were facing one week of quarantine, and then there's a few cases in the city and they end up with three weeks in quarantine. So, that's a very high degree of uncertainty to be imposing on the business community and just people more generally.

Another area that you touched on in your introduction, Eswar, is the housing market. Let's talk a little bit about that. What do they need to do to really contain this financial risks that are developing in the real estate sector? And do you see much prospect for real estate to come back and really contribute to economic growth? Or, is there a more fundamental issue that they've just built too much housing and it's going to take a while to work that through.

PRASAD: This has been widely documented, David, including in some of your work, of course, is that this sector is really important in terms of its contribution to Chinese GDP, to Chinese GDP growth, but it's also a very important component of household wealth. Right now we're seeing a situation where house prices are falling in a majority of the cities, be they first tier, second tier, or third tier. And that's having a significant negative effect on economic activity overall, especially insofar as the sector directly contributes to headline GDP growth.

But I think, and here the TIGER Index does have some evidence, that there’s a significant knock-on effect on consumer and business confidence.

Now, on top of the difficulties of the service sector has in generating growth as a consequence of the zero-COVID policy, we do have consumer spending beginning to show significant signs of weakness along with investment. So, there are these broad macroeconomic effects to consider.

Now, of course, at one level, what the Chinese government is trying to do is fix a problem of its own making. As we just discussed, the property sector has become very important to the economy and the central government, and especially the local governments who rely on land sales for a significant portion of their revenues, have been very happy to let it rip. That's created problems for the sector itself, a lot of imbalances in that sector, and it's also created financial system risks because there are many property developers who have overextended themselves and could create risks for the financial institutions, essentially the state owned commercial banks that have lent to them.

So, the government has been working with a while to bring some order to the property market or at least reduce speculative activity in this market. In other words, make it harder for people to get mortgages to buy second or third homes as investment properties. So, all of this, it may be well intentioned, but it's coming at a time when the economy is slowing and there is a great deal of uncertainty.

So, I think we are beginning to see the knock-on effects in terms of house prices, but also some financial system stresses building up because some property developers are coming under a lot of pressure.

I think we will continue to see a back and forth in terms of policymaking. In other words, there was a tightening of restrictions on the housing market. But now that that market is contributing to economic weakness, we are seeing some degree of support being provided by the government. So, I think ultimately we will converge to a point where the housing market is in slightly more stable territory. But before we get there, there is a lot more volatility to come.

DOLLAR: So, Eswar, you've been following the financial system and financial reform in China for a long time. So, broadening out a little bit from housing, what do you think are the main reforms that they need in the financial sector in order to get efficient growth and to limit the risks of financial crises?

PRASAD: So, China's economy, if you think about the long-term growth prospects, you know, there are a number of factors that are dragging down growth in addition to the shorter term issues that you mentioned, the other financial system weaknesses. There is a set of other factors related to unfavorable demographics and so forth. And of course, China's increasingly limited access to technology that it is trying to get from the rest of the world.

Now, all of this is important because the one way for China to maintain decent growth is by generating higher productivity. And for that, the financial system is going to be crucial because you need to have the high level of domestic savings and perhaps some foreign savings coming in as well, being directed to the most productive parts of the economy. And the financial system has not been working well. We haven't seen too many market-oriented reforms over the last ten years in the two Xi Jinping administrations. But the one message that does seem to have risen all the way to the top is the necessity of getting finance right. Because without that, it's going to be very difficult to achieve the economic objectives that Xi Jinping has set out for himself and his government.

But having said all that, the actual market oriented reforms in that dimension have been quite limited as well. It's not to say that there have been no actions. So, for instance, the greater ability of foreign financial institutions to enter the Chinese banking system, the insurance markets and so on, are adding to competition, potentially adding to efficiency. We have seen some measures to develop other parts of the capital markets, including the bond markets and equity markets, by giving foreign investors easier access to those markets.

But the banking system still remains crucial, and it's still largely in the hands of the state-owned banks. And we haven't seen much of an effect in terms of these reforms in getting them to improve their corporate governance, risk management, or credit allocation practices in a way that there is more financing available for small and medium enterprises in the private sector, and especially for service sector enterprises. So, some progress, but not a great deal and certainly not enough for China to accomplish what it needs to do.

DOLLAR: I think that's a very balanced assessment, Eswar. Xi Jinping is often given credit in the West as someone who has not really pursued economic reform, and I think you're right, there have been some important openings--financial services, direct investment. You know, they've also signed new trade agreements like the Regional Comprehensive Economic Partnership, which is the biggest free trade agreement in history. So, it's a more mixed picture, but I agree with your assessment of what's happening in terms of the main banking system in China and some of the fundamentals of how that works.

PRASAD: So, David, you, of course, are a very close China watcher. From your point of view, are we being unfair in terms of our assessment of other domestic reforms? I mean, we've talked for a long time about real side supply reforms and so on. Have you seen much progress, any of those areas yourself?

DOLLAR: No, I think you pointed to the main areas where I would give Xi Jinping some credit: the direct investment, not just financial services, but also automobiles, liberalizing that and trade. But not much else. I think this phrase "common prosperity" does not have a lot of substance behind it. Xi Jinping is proud that they've continued to make progress on poverty reduction, but it's more or less a long term trend. Under Xi Jinping, GDP growth averaged about 6%, and that's rapid enough to continue the poverty reduction. It's been going on for a long time. So, I don't see that there were any special redistributive measures there, just continuation of growth up till now.

And then they've failed at some obvious things like introducing a property tax, might have some influence on some of the things you mentioned. So, overall, I think there's disappointment in his reform track record, but we both, I think, put in some important nuances, that storyline that nothing has happened for ten years, I think that's excessive and not really fair to the Chinese side.

PRASAD: It's interesting to note that in the speech over the weekend, Xi Jinping did make reference to the dual circulation framework, which I interpret as trying to engage with the rest of the world on China's own terms. In other words, China would like to continue having access to global markets. It would like to continue being able to acquire technology from the rest of the world. But China wants to reduce its reliance on the rest of the world in both of those dimensions and make itself less susceptible to external shocks. This has been a longstanding policy of theirs. Do you see it having any material effect in terms of how they conduct reforms and orient them, either in terms of domestic policies themselves or in terms of their engagement with the outside world?

DOLLAR: Eswar, I find the concept of dual circulation somewhat confusing. We want strong domestic demand and a lot of domestic production meeting that demand, but we also want to be part of the world economy. And so, I think it's a little bit confused. And in some areas they have these pretty ambitious desires, like cutting down on their dependance on imported semiconductors. But so far, we don't see any evidence that they're succeeding at that. That's just a lot harder to do than it is to say.

There's a lot of investment going on in China, in semiconductors, for example, but it's mostly the low tech end of the sector and Taiwan is continuing to build semiconductor fabs, the U.S. Ironically, we may end up with a glut on the world market now that everybody's subsidizing semiconductors. But China is still importing vast quantities, and I think it's going to be hard for them to really move away from that.

I mean, that kind of leads to another question, and I think one you indirectly touched on already, but I was going to say maintain their productivity growth, but actually that's slowed down a lot. So, they kind of need to rebuild it. Can they do that as their external relations become more difficult with the U.S. and Europe and some other key partners?

PRASAD: Yeah, that's going to be a significant challenge. At one level over the past couple of decades, one way they did generate some degree of productivity growth has been by moving workers from the less productive parts of the economy to the more productive parts. But that dynamic might have played itself out. There is a little bit more room with some workers in the rural areas who could be brought into the urban areas.

But the reality is that they're also trying to move away from low skill, low wage manufacturing, for instance, towards higher tech, higher value added industry. And at the moment, the ability of China, despite the indigenous innovation objectives and so on, to generate the sort of innovation that could support the high tech sector is quite limited.

Now, as you've pointed out, there are attempts to create investments that could backstop such industries, and perhaps in terms of green technologies and so on China is certainly trying to set the standard for the world and seems to be hopeful that it can generate innovation in that area that allows it to create domestic growth dynamism, but also perhaps capture a significant share of global markets.

But it's become clear that there is this overarching economic philosophy that has become prevalent over the last few years, that the private sector is allowed to play a role in the economy so long as it remains within control and does not show any signs of becoming economically or politically a challenge to the government. We've already seen measures to take down some of the big tech companies that were seen as growing too big for their britches.

So, the interesting question is whether China can have it both ways. That is, have a dynamic private sector that is able to innovate while at the same time the Communist Party wants to make sure that no private enterprise grows to a scale where it ends up challenging the dominance of the party and its control apparatus in any way.

And it's also worth thinking about how this fits in to the common prosperity agenda, because clearly the government does not want to see any mega rich people flaunting their wealth because that is seen in some way as inconsistent with what the government is trying to do in spreading the wealth.

So, there are a lot of conflicting objectives at play and in that environment and with the additional element of uncertainty created by the economic and domestic political shifts in the wind, it's hard to see how private enterprise can create the sort of dynamism that is essential for better productivity growth. And then, of course, as we already discussed, getting finance right is going to be crucial as well.

So, it's clear the government knows what needs to be accomplished in terms of getting better productivity growth. It's not clear it's willing to take those steps, though.

DOLLAR: Eswar, I also want to ask you about the Chinese currency, the renminbi, something that you've written about extensively. It's depreciated quite a bit against the U.S. dollar this year. So, can you give us your sense of what's going on with the renminbi and is that likely to be a continuing trend? I know we can't forecast exchange rates. If we could, if we could forecast the short run movement, we'd be rich. But in general terms, what do you see as the trend there?

PRASAD: So, what's happening with the renminbi is what's happening with practically every other currency relative to the U.S. dollar, because the U.S. has been tightening monetary policy quite aggressively through interest rate hikes by the Fed. The U.S. economy seems to have better growth prospects in the short term, relatively speaking, than most other major economies. So, those macroeconomic factors, plus of course the fact that you have flows into the U.S. dollar at times of economic turmoil because the U.S. dollar remains the dominant safe haven currency in the world--all of those factors are contributing to general dollar's strength.

So, if you look at the renminbi over this year, it's depreciated by about 12% relative to the U.S. dollar, only by a few percentage points on a trade weighted basis. So, at one level, one might argue that this is hardly major downward pressure because after all, China still has about $3 trillion of foreign exchange reserves. And if you have depreciation of about somewhere in the range of 4 to 6% on a trade weighted basis, that's hardly any reason to be concerned. And it may actually be the right sort of buffer for an economy that is weakening.

But the reality in the world, which again, is not particular to China, is that the one exchange rate that matters the most is that relative to the U.S. dollar. So, I think that is a significant concern right now that given that Chinese inflation remains quite low, given that China's economy could certainly use a policy boost, if anything, we're going to see monetary policy easing rather than tightening in China, while the U.S. and many other advanced economy central banks might continue their interest rate hikes.

So, that creates this very dangerous dynamic of capital outflows and currency depreciation, which again, as happened in the case of the period during 2015 when an anti-corruption drive was going on as well. Right now, given that the political firmament is becoming clearly dominated by Xi Jinping, who may decide that he wants to bring the hammer down on those who he doesn't see as loyalists, which could include other government officials, but also people in the private sector. We might see some of that capital beginning to fly out of China, too.

So, I think there is significant risk of further currency depreciation. My sense is that can be managed. I think the government does have enough policy tools, but the ability to restrict some of those capital outflows with the ability to deploy some of the reserves that it has. But it is certainly a slightly fraught time for the Chinese currency.

DOLLAR: Eswar, I'd like to end with a highly speculative question. It seems very unlikely that Xi Jinping will get at least another five year term coming out of this Party Congress. So, looking ahead, what do you think is more likely. that he'll double down on the existing policies which have produced relatively slow growth, or do you think we'll see at least a partial recommitment to reform and the growth agenda?

PRASAD: So, David, as you've pointed out, I think the highly likely outcome is that Xi Jinping does continue into a third term at least. But what is going to be far more interesting at the end of the week, the end of the Party Congress is who remains in the Politburo Standing Committee and what some of the other major appointments of the technocratic level are. These people who largely shared his vision of a command-led economy being what China should aim for, or if we will have some reformers who continue to at least create some room for market oriented reforms within the broader context of Xi Jinping's vision.

My sense is that based on all the statements we've seen in the last few months and this weekend's speech that we're going to see a doubling down on a shift towards a command economy. Again, with the private sector seen as playing a useful but relatively circumscribed role in the economy and command-led economy being seen as the way to ensure that the Communist Party of China retains its control of the economy and tries to make the economy more self-reliant.

DOLLAR: I'm David Dollar, and I've been talking to my colleague Eswar Prasad. 20th Party Congress is going on in Beijing, and we've been discussing the economic issues, which I hope they're tackling behind closed doors. But it's hard to know what's going on in the black box. But we've had a good conversation about the very daunting challenges that China faces with COVID policy, with the housing crisis, with its external relations, with its control over the private sector. So, thank you very much, Eswar, for sharing your expertise.

PRASAD: Thank you, David, for having me back on your show and it's always a real pleasure.

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Until next time, I’m David Dollar and this has been Dollar and Sense.