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Breaking China’s Investment Addiction

BEIJING – China’s economic growth model is running out of steam. According to the World Bank, in the 30 years after Deng Xiaoping initiated economic reform, investment accounted for 6-8 percentage points of the country’s 9.8% average annual economic growth rate, while improved productivity contributed only 2-4 percentage points. Faced with sluggish external demand, weak domestic consumption, rising labor costs, and low productivity, China depends excessively on investment to drive economic growth.

Although this model is unsustainable, China’s over-reliance on investment is showing no signs of waning. In fact, as China undergoes a process of capital deepening (increasing capital per worker), even more investment is needed to contribute to higher output and technological advancement in various sectors.

In 1995-2010, when China’s average annual GDP growth rate was 9.9%, fixed-asset investment (investment in infrastructure and real-estate projects) increased by a factor of 11.2, rising at an average annual rate of 20%. Total fixed-asset investment amounted to 41.6% of GDP, on average, peaking at 67% of GDP in 2009, a level that would be unthinkable in most developed countries.

Also driving China’s high investment rate is the declining efficiency of investment capital, reflected in China’s high incremental capital-output ratio (annual investment divided by annual output growth). In 1978-2008 – the age of economic reform and opening – China’s average ICOR was a relatively low 2.6, reaching its peak between the mid-1980’s and the early 1990’s. Since then, China’s ICOR has more than doubled, demonstrating the need for significantly more investment to generate an additional unit of output.

As the accumulation and deepening of capital accelerate growth, they perpetuate the low-efficiency investment pattern and stimulate overproduction. When production exceeds domestic demand, producers are compelled to expand exports, creating an export-oriented, capital-intensive industrial structure that supports rapid economic growth. But if external demand lags, products accumulate, prices decline, and profits fall. While credit expansion can offset this to some degree, increased production based on credit expansion inevitably leads to large-scale financial risk.

Thus, a combination of investment, debt, and credit is forming a self-reinforcing risky cycle that encourages overproduction. In the wake of the global financial crisis, Chinese banks were instructed to extend credit and invest in large-scale infrastructure projects as part of the country’s massive monetary and fiscal stimulus. As a result, China’s credit/GDP ratio rose by 40 percentage points in 2008-2011, with most of the lending directed toward large-scale investment by state-owned enterprises (SOEs). In the last two years, bank credit has become the main source of capital in China – a risky situation, given the low quality and inadequacy of bank capital.

Meanwhile, strong currency demand has led China’s M2 (broad money supply) to increase to 180% of GDP – the highest level in the world. The massive wall of liquidity that has resulted has triggered inflation, sent real-estate prices soaring, and fueled a sharp rise in debt.

Given that it is in local governments' interest to maintain high economic-growth rates, many are borrowing to fund large-scale investment in real estate and infrastructure projects. The active fiscal policy adopted during the financial crisis enabled the rapid expansion of local official financing platforms (state-backed investment companies through which local governments raise money for fixed-asset investment), from 2,000 in 2008 to more than 10,000 in 2012. But, as local-government debt grows, Chinese banks have begun to regard real estate and local financing platforms as a major credit risk.

Likewise, with key industries facing overproduction and slowing profit growth, firms' deficits are growing – and their debts are becoming increasingly risky. Indeed, the proportion of deficit spending among enterprises is on the rise, and the accounts-receivable turnover rate is falling. By the third quarter of 2012, industrial enterprises' receivables totaled 8.2 trillion renminbi ($1.3 trillion), up 16.5% year on year, forcing many to borrow even more to fill the gap, which has driven up debt further.

According to GK Dragonomics, corporate debt amounted to 108% of GDP in 2011, and reached a 15-year high of 122% of GDP in 2012. Many heavily indebted companies are SOEs, and most of the new projects that they initiate are "super-projects," with the return on investment taking longer than creditor banks expect. Indeed, some highly indebted firms' capital chains may well rupture in the next two years, when they reach their peak period for debt repayment.

As a result, China's financial system is becoming increasingly fragile. The expansion of infrastructure investment – which, according to some reports, exceeds 50 trillion renminbi, including highway and high-speed railway construction – will lead to the expansion of banks' balance sheets. The investment loans and massive debts among local financing platforms, together with the off-record credit channeled through the "shadow" banking system, are increasing the risk that non-performing loans will soon shake the banking sector.

To reach the next stage of economic development, China needs a new growth model. Reliance on investment will not enable China to achieve stable, long-term growth and prosperity; on the contrary it may well inflict serious long-term damage on economic performance.

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— Una creciente inestabilidad política: esto se una emergente clase media que reivindica par mayor participación en la toma de decisiones y

progresivas libertades. Y China se encuentra, a
situación, donde las clases medias han visto c
ingresos y fortunas de una pequeña élite han a
mientras que los niveles de vida de todo el res
estancado. Esto ha generado intensa movilizac
en contra de esta enorme desigualdad.

— El segundo problema que enfrenta China es
nivel de degradación ambiental. La mayor part
están fuertemente contaminados. 320 millone
no tienen acceso al agua. El 70 por ciento de l
altamente contaminado. Hace poco, una dens
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Chengdu y Zhengzhou, y que ha abarcado la mi
el 2012, la polución ha causado la muerte de 8,

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Often only investment and export are named t
economies. Those who dare to talk about cons
middle class are socialists. China and Germany
with this model but in the end it can not work f
forever.

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Michael Pettis has raised similar concerns that
debt growth is far higher than the debt servici
by citing the recent declarations by the Centra
Secretary, he shows that there is still room to
policy stances that is based on maintaining bal
economic growth and perseverance with mark
reforms in the face of multiple risks in the eco
helmsman of China's ruling party is on record,
government should continue its proactive fisc
monetary policies next year and improve the e
internal vigor and dynamic. The growth that we
be tangible, not exaggerated growth, and shou
of good quality and sustainable," Xi said.

If marginal ICOR is rising, which in true sense is
beyond a threshold, it is an indication of the lir
consuming at a rate that is not sustainable; the
commodity prices are already showing signs o

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style period of economic r
liberalization in North Kore

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frighteningly anti-democra
implications of the Trans-P
Partnership.

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Erdoğan's Self-Infli

DANI RODRIK says that Tu
minister has only himself t
the country's current politi