China's Challenges

Observations from 25 Years
of
Teaching About the Economy

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Key Issues

- Agriculture – Urban Linkages
  - The Burden of Incomplete Land Reform
- Financial Deepening
  - The Burden of Financial Repression
- Public Goods Provision
  - Who funds, who provides: vertical structure of public finance
- Savings-Investment Balances
  - High private and business savings

<u>Agriculture</u>: Land Grabs aren't the issue

- underlying issue is unfavorable elasticities
  - output per unit of land is much higher
    - offset by higher inputs for
      - commercial seed
      - chemical fertilizer, herbicides, and pesticides
      - water [though that is underprice in much of China)
      - tools (including tillers and tractors and trucking services)
  - labor inputs to land are much lower
    - so physical output per hour worked has not risen
      - net of inputs, the story is worse

agriculture and land (cont)

- so what has happened to prices?
  - income elasticities and price elasticities of agriculture are unfavorable
  - despite income growth, prices don't make working small plots of land profitable
    - hence the labor outflow from the agrarian sector
  - under the current landholding farmers cannot earn a competitive income, and the situation will only worsen

agriculture and land (cont)

- land grabs are unethical but
  - only affects a minority of farmers in certain (unfortunate) geographies that make land ripe for harvesting as a local income source.
- lack of clean ownership rights
  - affects ***ALL*** farmers
- 1950 land to the tiller policy
  - plus additional redistribution
  - previous system of muddy rights to land
    - complicated layers of title and tax obligations
    - current situation similar: land is not “free & clear”

agriculture and land (cont)

- titular control is with local government
  - and venality is well known
  - 10s of thousands of officially counted protests each year over reassignment from farmers to developers
    - without, of course, much compensation
    - no studies of how many transfers occur with adequate compensation. my sense is that in the 1980s this process was

agriculture and land (cont)

- **however**
  - in practice about 20% of farmers rent in land
    - no other developing country has anything like that!
  - the normal tenure issues exist
    - those renting land invest less in maintenance
      - offset by less expensive fertilizer and other inputs
- **but**
  - subsidies now widespread and rising
    - rural taxation has been totally abolished
    - almost 80% of farmers receive cash subsidies
      - ≈ US$35 per acre so while small at household level, not trivial
  - hence from a fiscal perspective land issues loom large

Fiscal Structure

- tax revenues flow to the center
  - urban land grabs the key source of urban revenue
  - rural areas rely increasingly on transfers
    - how allocate transfers?
- how bolster local revenue sources?
  - trial balloons for urban real estate taxation
- meanwhile debt financing
  - not transparent
    - with presumption that there are lots of low-payoff projects
      - except perhaps in that those involved pay off each other

Financial Deepening

- in Japan two sources of finance
  - banks started by landed elite in late 1800s
    - stock and bond markets followed
  - legitimization of informal financial institutions
    - village "savings clubs" and rural moneylenders
      - ➔ Mutual Savings Banks, Credit Associations
- how to support informal
  - and gradually institutionalize
- ***issue is poorly studied***

Financial Repression

- low nominal deposit interest rates
  - often below inflation
    - common to developing countries
    - distortions well-known
- in a life-cycle model depresses consumption
  - raises savings as need to set aside more for retirement
- passed on to borrowers
  - but SOEs and city governments don't need subsidies!!
    - capital in China should be expensive, not cheap
    - distortions amplified by slow pace of financial deepening

Micro-macro Balances

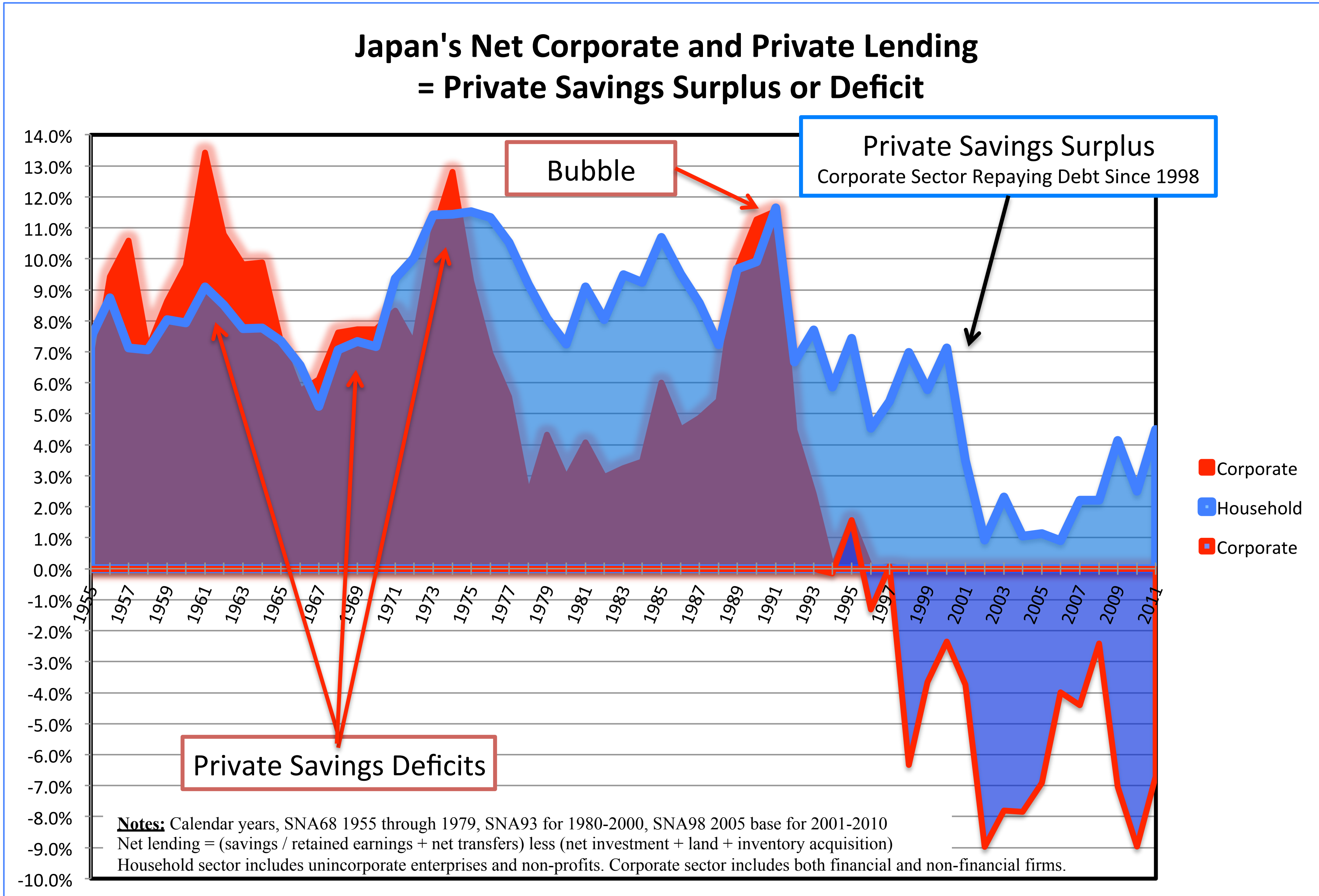
- High personal savings reflect
  - (i) demographics
  - (ii) financial repression / shallow financial sector
  - (iii) underprovision of public goods
    - lack of social insurance: healthcare, pensions
    - private markets don't exist or (as in US) don't work well
    - Chinese who grew up in the 1960s were taxed for this while young
      - but receive nothing now: morally noxious!!

Savings-Investment Balances

- at present high household savings & high corporate retained earnings
  - SOEs don't pay dividends to the State
    - lots of wasteful activities and "wealth transfers"
- open economy balance
  - $(S - I) + (T - G) \equiv (X - M)$
    - government already spending a lot, but small deficit
    - so translates into trade surplus / intl capital flows
      - from which Chinese citizens do not benefit

S-I balances

- With inevitable growth slowdown
  - Investment “I” will fall
    - exacerbating
    - remember our Solow model!
  - but demographics will move more slowly: “S” will remain high
    - the Paradox of Thrift
    - unless savings fall
      - trade surpluses must increase
      - not feasible since China is large in the global economy
  - hence government as borrower of last resort
      - to soak up private savings
  - Japan as example of chronic excess savings



Japan's Net Corporate and Private Lending
= Private Savings Surplus or Deficit
Bubble
Private Savings Surplus
Corporate Sector Repaying Debt Since 1998
Private Savings Deficits
Corporate
Household
Corporate
14.0%
13.0%
12.0%
11.0%
10.0%
9.0%
8.0%
7.0%
6.0%
5.0%
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2011
Notes: Calendar years, SNA68 1955 through 1979, SNA93 for 1980-2000, SNA98 2005 base for 2001-2010
Net lending = (savings / retained earnings + net transfers) less (net investment + land + inventory acquisition)
Household sector includes unincorporate enterprises and non-profits. Corporate sector includes both financial and non-financial firms.

Scenario for An Old China

- Retirement at the macro level
  - must be pay as you go
    - current consumption (incl healthcare) of retirees must come from current production
- tensions
  - private systems can fail at that
    - when baby boomers retire they sell assets
      - but who's left to buy in an aging population?
      - in which case diligent savings leads to penury in old age
  - public tax-and-transfer inevitable
    - in the face of the reversal of the second demographic dividend

- when private savings are high, no underlying tension
  - only whether institutions will make that transfer
    - for those lucky enough to have assets, sell to savers
    - for others the govt must borrow to finance pensions & health
- when private savings fall
  - consumption of those in the workforce crowds out consumption of retirees
  - not politically sustainable, not ethically acceptable
    - so tax (to depress consumption) and transfer (to retirees)
- Chinese government as insurance company
  - over time shift from the provision of public goods
  - to the provision of old age security