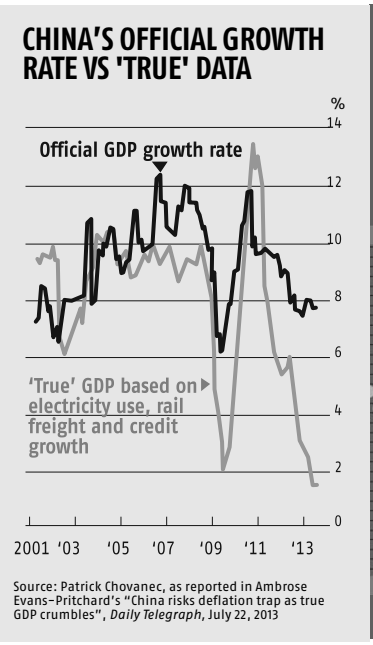

Source: Patrick Chovanec, as reported in Ambrose Evans-Pritchard's "China risks deflation trap as true GDP crumbles", *Daily Telegraph*, July 22, 2013

ILLUSTRATION BY BINAY SINHA

China's statist turn: hubris to nemesis?

Economic rebalancing would strike at the heart of the Communist Party of China's interests, says **Deepak Lal**

An obvious question arises from my last two columns, which described China's statist turn since the Great Recession: will its hubris be followed by nemesis? The answer turns on whether, as the leadership has continued to emphasise, China is able to shift from its statist debt-fuelled investment model to the more market-friendly, consumption-led model of the 1980s and early 1990s.

The typical denouement of other debt-fuelled investment surges in past sovereign debt crises in developing countries and the current one in the Club Med countries is ruled out, given China's closed capital account, inconvertibility of the renminbi and its limited foreign sovereign debt. "There is simply no way that offshore speculators, investors, hedge funds or others can get at China's domestic debt obligations and challenge the Party's valuation of these obligations..."(*Red Capitalism,* authored by Carl Walter and Fraser Howie).

Much more serious are the declining returns from this debt-fuelled investment. From various estimates made by different observers, it seems that now for every RMB 1 of nominal GDP growth, RMB 3.3 of new credit is required ("China is having a credit-fuelled non-recovery", *Financial Times*, April 15, 2013). This has led to a slowing of China's growth rate, even in its dubious official figures.

If we go by the "Li Keqiang index", compiled by Professor Patrick Chovanec at Tsinghua University *(see graph)*, it appears that Chin's economic growth has collapsed to under two per cent. According to a WikiLeaks cable, when Premier Li Keqiang was a regional party chief, he looked at electricity use, rail freight and credit growth to measure China's economic growth, as against the official Chinese data. This led to the creation of "Li Keqiang index".

The problem lies in the continuing financial repression with a wide spread of 3-3.5 per cent between the administratively determined deposit and lending rates. Besides, China has kept these rates four to six per cent below the Wicksellian natural rate of interest, which balances savings and investment. As Michael Pettis notes in *The Great Rebalancing,* the combination of these two means of financial repression is, in effect, a large hidden tax on household income, which cleaned up the banking crisis of the 1990s. This explains the systematic divergence between the high GDP growth and the substantially lower growth of household income in the post-1989 period. It meant that the share of household consumption, which was already low (at 45 per cent in 2000), reached a low of 36 per cent in 2010.

The rebalancing of the economy requires ending financial repression. This will not only eliminate the current high tax on household savings, but also allow an end to the massive misallocation of capital. The former will lead to a rise in the consumption share, making domestic consumption – not trade surpluses and infrastructure investments – the main source of growth. The latter will lead to productive investments, instead of debt-financed investment rising much faster than the growth in debt-servicing capacity.

But is this likely? The rise in interest rates required to end financial repression will cause extreme economic pain to state-owned banks and enterprises — and also to the local governments inside China Inc, which are addicted to low rates and have built up large debt-laden balance sheets. As was seen in the 1990s, clearing up this financial drag on growth will probably require a continuance of this financial repression till households, in effect, clean up this surge in non-performing loans. But this will go against the proclaimed aim of raising the share of consumption to maintain social stability.

One way out would be for the state to end financial repression, thereby giving a boost to household incomes and cleaning up the toxic balance sheets by recapitalising the banks through "some form of direct or indirect privatisation of state assets" (*The Great Rebalancing*). Also, as the required rebalancing necessitates a reduction in the investment share of GDP, the resulting growth rate of GDP will necessarily have to fall.

Another spectre haunts China's desire for social stability. These are the growing social protests against widespread official corruption and arbitrary exercise of state power to confiscate property. Martin King Whyte, in "China needs justice, not equality" (*Foreign Affairs,* May 5, 2013), reported that, "according to confidential but widely circulated Chinese police estimates, there are now about 180,000 mass protest incidents each year, roughly 20 times more than there were in the mid 1990s." Xi Jinping, the new Chinese leader, and his colleagues have expressed alarm at these increasing protests, and believe they are caused by rising inequality. But Professor Whyte finds in his surveys that Chinese are not worried about these income inequalities. China – much like America and India – is an aspiring, not egalitarian, society.

Currently, it is the procedural injustices and massive official corruption that are fuelling public anger and mass protests. But most measures that would address this, "such as greater judicial independence, press freedom, and genuine guarantees of freedom of association and peaceable assembly – not to mention allowing electoral challenges to those in authority – would strike at the heart of the Communist Party of China's Leninist principles".

This is the nub of the problem China faces. It does not have the rule of law, which is embodied in Western legal traditions and was adopted by India in the 19th century. It involves the substantive separation of the judicial and executive functions of the government — governmental executive decisions can be contested in civil courts, and governments abide by a judicial decision even if goes against them. India provides such a legal system, even if it is dilatory. It is because of this difference vis-à-vis China that, despite similar current travails, India's long-term economic prospects remain brighter.

Will the oligarchy of "princelings", who increasingly control the Communist Party of China and have benefited handsomely from state-led authoritarian capitalism, accept these economic and legal reforms? In summing up the lessons from his comparative millennial quantitative economic history of China, Angus Maddison wrote in *Chinese Economic Performance in the Long Run* that China's "reform process has been legitimised as a modification of socialism rather than an embrace of capitalism. However, a prolonged continuation of this situation will weaken the performance of the economy. Under the imperial regime, the Chinese economy was overtaken by the West, in good part because the West developed a legal system and an institutional framework in which capitalism could flourish, in which profit seeking rather than rent seeking had a bigger role than in China". This advice needs to be heeded if China's hubris is not to be followed by its nemesis.