LARDY

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Andrew K. Semmel
Executive Director
U.S.-China Commission
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Dear Mr. Semmel,

I have read the paper on China's future capital needs, which the Commission requested from Gordon Chang, and am writing to offer my reactions and evaluation.

There is much in the paper that is quite interesting, which the Commission will find of value. It pulls together a great deal of information from a diversity of sources.

My main reservation, however, is that the author systematically overlooks evidence and information that runs counter to his hypothesis that China's economy is stalling and that its need for external capital will rise sharply in coming years. Perhaps some examples will make this clear. I hasten to add that Mr. Chang's prognosis may prove correct. But he does not appear to have examined all of the evidence available before coming to his conclusions.

Take first the question of China's economic growth over the past four years (1998-2001), discussed in detail in Appendix 1 of the paper and underlying much of the analysis in the main text. Mr. Chang cites a number of studies suggesting that growth in this period has been far below the level claimed by the Chinese statistical authorities. Official data suggest growth of 34.4 percent in real terms. The most comprehensive alternative estimate, produced by Professor Rawski, is that cumulative growth in 1998-2001 is in the range of from 0.4 to 11.4 percent. Mr. Chang cites a number of other studies but offers no independent growth estimate himself.

Measuring GDP growth everywhere is a complex process and China it may be more difficult because of an admitted tendency of lower level administrative units to exaggerate industrial output produced in their jurisdictions. Thus Mr. Chang quotes Professor Rawski's argument that one should analyze politically less sensitive figures that are less likely to be manipulated to judge the plausibility of the official growth figur□s. I agree that this is a useful potential check on the order of magnitude plausibility of the official growth figures. But not all of these figures support the view that economic growth in the recent past is far below government claims.

Take fiscal revenue. In the four-year period it rose about 80 percent in nominal terms. Because the government, as Mr. Chang correctly points out in his paper, faces increasing demands to provide an ever growing range of services, the Ministry of Finance is unlikely to exaggerate the resources at its disposal. It would appear somewhat unlikely that fiscal revenues could rise by as much as 80 percent in an economy where economic growth was 11 percent or less. When growth slows down the usual experience is that revenue growth declines even more rapidly. Even with the tax reforms underway at the time it would seem unlikely that fiscal revenues could rise by as much as 80 percent without fairly robust real economic growth. The fiscal data, of course, don't prove that the official GDP numbers are precisely accurate. But they don't support the hypothesis that growth has collapsed.

Another useful check on the growth numbers is the change in imports. Again these data are not likely to be manipulated. They are collected by an agency of the central government, the General Customs Administration, not provincial officials. And there is no incentive to overstate imports since the Customs must collect tariff revenue on imports and hand it over to the Ministry of Finance. Imports in the 4 years 1998-2001 grew by just over 70 percent. Import growth is a function of changes in relative prices and changes in income. On the price side there are two factors to consider: changes in the real value of the domestic currency vis a vis currencies of trading partners and changes in tariffs and non-tariff barriers that could influence the prices of imports relative to prices of domestic goods. There was some appreciation of the yuan in the early stage of the Asian Financial Crisis. But the IMF calculates that by 2000 the value of the Chinese currency had returned to where it was pre-crisis. Thus we can rule out yuan appreciation, which would make imports cheaper than domestic goods, as a source of import growth. On the price side tariffs declined 10 percent over the four year period (see my new book Chapter 2 for details). Making a reasonable guess the price elasticity of demand for imports might be 1.5, meaning when tariffs fall by 10 percent imports would expand by 15 percent. It is difficult to estimate the effect of declining non-tariff barriers but based on my analysis of the effect of the phase out of import quotas and licenses (Chapter 4 of my book) it is likely to have been small during the period in question. Most of the existing import quotas and licensing requirements were phased out prior to 1997. In short we are left with 55 percent growth of imports to explain. Again is this most plausibly explained by economic growth of from 0.4 to 11.4 percent or by growth of about one-third? If we take the mid-point of Professor Rawski's estimated range of economic growth, 5.9%, the implied income elasticity of demand for imports is about 10. That is we would have to believe that a one yuan increase in income would generate about a ten yuan increase in the demand for imports. This is far, far out of the range of international experience and is totally implausible. The one-third GDP increase implies an elasticity of about 1.9 (= 55/34.5). This is somewhat high, indicating a considerable degree of openness of the Chinese economy (in most of Europe and Japan I believe the comparable numbers are about one or a little under one indicating that when income grows by 1 unit imports go up by something less than 1; the US is one of the few economies where the elasticity is significantly greater than 1). Again this analysis does not prove that 34.5 percent is an exactly correct measure of economic growth in the four years 1998-2001. But it does suggest that the estimate of cumulative growth of 11 percent or less over the four year period is not plausible.

I could go on with other examples of this type. The point is simply that, despite what Mr. Chang refers to as a "growing chorus" of criticism of the accuracy of official data there remains considerable uncertainty as to the actual growth rate of the Chinese economy in recent years. Mr. Chang appears to simply accept the view of the critics without looking at contrary evidence, some of which I have just summarized. Then in the main body of his study he takes as given that the Chinese recent growth rate has been far below official claims and, more importantly, future growth will be modest and declining (figure 2.5). That, in turn, underlies the estimated initial (2002-2003) modest growth and subsequently (2004-2005) absolute decline in fiscal revenues. Given the uncertainty of any growth forecast, it might have been analytically more useful to present a couple of alternative scenarios with varying underlying rates of economic growth and thus differing revenue growth and alternative funding requirements.

Another topic on which I would think it useful to present additional scenarios is inward foreign direct investment. Mr. Chang hypothesizes that as foreign investors realize that China's underlying economic growth is less robust than they had believed and is likely to sink even lower in the future that they will cut back on their investment plans for China. The uncertainty on the growth side, discussed above, should also be reflected in alternative forecasts of FDI inflows. It is certainly worth noting that profitability of foreign investment in China has been rising in the last few years. Combined with the opening up of new sectors such as telecommunications, financial, and distribution services, one might anticipate that foreign investment inflows would continue at fairly high levels (ca US$40-45 billion level) observed in 2000-2001 or perhaps even rise somewhat rather than falling sharply (figures 2.3 and 2.4). At least the alternative scenario should be presented.

One additional suggestion on the estimate of future capital needs. The major driver of rising expenditures is the need to finance bank recapitalization. This shows up in the author's estimate for expenditures in 2004 and 2005 (figure 4.1). But analyzing the costs of bank recapitalization in such a short time period is at least questionable. Everywhere the problem is as large as it appears to be in China the costs of recapitalization are spread out over a period of many years through the use of government bonds. Thus the expenditure requirement arises from the need to pay interest on the bonds that are issued as part of the bank recapitalization program. It would be useful to explain more clearly the basis of the US$34.5 billion expenditure requirement and to extend the time period of analysis. The IMF methodology for estimating fiscal sustainability would be one alternative approach that might be employed.