China's Rise and the Global Financial Crisis

Nicholas R. Lardy, coauthor of China's Rise: Challenges and Opportunities*, assesses China's economy slowdown, what China can do about it, and its impact on the global economy and financial crisis.*

Steve Weisman: Welcome to Peterson Perspectives. This is Steve Weisman of the Peterson Institute for International Economics. Our guest today is Nicholas Lardy, Senior Fellow at the Institute and author of the new book, *China's Rise*. Coauthors are Fred Bergsten at the Institute, and Derek Mitchell and Charles Freeman at the Center for Strategic and International Studies (CSIS).

China has been called one of the drivers of world economic growth and yet you have written recently that its economic growth is slowing down. How much is it slowing down and why is that?

Nicholas R. Lardy: Well, it has now slowed on a quarterly basis about three percentage points from its peak in the second quarter of 2007. And there are really two reasons. The first is that its export sector is slowing down; its contribution of its trade to its own growth has come down a little bit. And secondly, they're beginning to have an adjustment in their property sectors, so that construction activity has slowed. So those are the two main factors slowing the growth down.

Steve Weisman: The world has come to expect China to have a high growth rate to prop up the global economy. Is the fact that China is slowing down a threat now at a time when the global economy is under strain for a lot of different reasons?

Nicholas R. Lardy: Well, it is true, particularly if you go back to the tech bust in 2001 and the aftermath of that. China's contribution to global growth was enormous because the advanced economies slowed down. And they have continued to contribute significantly to global growth over more recent years because their growth has been accelerating and reached a peak of almost 12 percent in 2007. So this slowdown now is coming at a very inauspicious time because global growth is slowing, and China's contribution to global growth is going to shrink significantly going forward, because China's growth slowdown is not just the result of slowing exports, but also because of the slowdown in its domestic activity, particularly in the construction sector.

Steve Weisman: You’ve suggested in some of your recent pieces, though, that this slowdown could actually be an opportunity for China to adjust its policies in a better way. What would you suggest China do in that regard?

Nicholas R. Lardy: Well, I think the best prospects for sustaining a relatively rapid growth in China are to try to encourage domestic consumption, expenditure, which basically means household spending. Household spending has lagged behind the growth of the economy in recent years, so the share of the economy that’s accounted for by the household sector is very, very small compared to other countries. So the government could adopt policies to encourage consumers to spend more, and that means, of course, saving less. That would add to economic growth, and I mean their slowdown could be significantly less than it would otherwise be.

Steve Weisman: Of course, the United States has been advising China to rebalance its economy and spur consumer spending. Is there any reason to believe China will do that now?

Nicholas R. Lardy: Well, this has been their official policy also for several years. They’ve taken some steps in this direction. Government consumption, that is government provision of social services in some areas, has improved significantly over the last two to three years. There’s much more to be done. So the government itself could have a much higher level of expenditures on social programs. And that would give people some confidence that their healthcare needs, education, and pensions would be financially sound, and they wouldn’t have to save quite so much themselves to self-finance all of those activities. It’s a slow process, but it’s certainly one that is within the realm of possibility, that government could encourage households to spend more just by demonstrating that a larger effort is going to be made on the part of the government in providing services.

Steve Weisman: What are some of the ways that they would spur consumer spending?

Nicholas R. Lardy: Well, one thing they’ve done, for example, is to roll out in the countryside a cooperative healthcare system. In the old days when China still had communes, they did have a kind of primitive insurance scheme; the collective bodies kept some income to cover major health expenditures for their members. It wasn’t a very high level of coverage or anything like that. But in the wake of the rural reforms, the collective system basically collapsed and nothing came along to replace it, so healthcare expenditures became almost the sole responsibility of individuals. So they started saving a lot of money in case a member of their family got sick.

Starting about three or four years ago, the government rolled out what at the time they called an experimental rural cooperative healthcare system. And that is a system in which the individual makes a contribution, a financial contribution, to an insurance pool, the local governments make a contribution, and the central government makes a contribution. That provides a pool of funds that can be used to defray expenditures if someone from the rural area has to go to the hospital.

Now, there are large deductibles, sometimes there are significant uncovered expenses, so that program could be strengthened so that the extent of coverage would be greater. That just started only five years ago; now it covers about 80 percent of all farmers and rural people in China. So this has expanded very rapidly over the last five years, but it could use more financing.

Steve Weisman: What about interest rates in the banking system?

Nicholas R. Lardy: Well, in the banking system, the biggest problem has been that the real interest rates that savers get on their savings accounts have been going down because the nominal interest rates have not been adjusted as inflation has risen over the last five years. So in effect, households are being taxed. In fact, particularly this year, they're being taxed quite heavily because inflation is now up around five, six percent, and the typical deposit pays less than one percent in interest. So the real return is negative. And that means that household income is much lower than it would be if they didn't have this implicit tax built into their banking interest rates structure. So that's another opportunity the government could take. Raise the interest rates on savings, at least in deposit territory, that would add significantly to household income and that would stimulate more private consumption.

Steve Weisman: We are talking, of course, at a time of global economic instability. China is sitting on, by some measures, nearly $2 trillion dollars in reserves. Is there a role for China to play in the rescue or bailout of financial institutions in the West?

Nicholas R. Lardy: Well, of course, over the last couple of years the Chinese have made some investments already before the crisis hit in Western financial institutions. Their new China Investment Corporation, for example, which has some elements of being a sovereign wealth fund, made an investment in the Blackstone Group, a private equity group. They've also invested money in Morgan Stanley. So the Chinese have been slowly moving a little bit in that direction.

But it's important to recognize that even though they have two trillion in foreign exchange reserves, they've already given us that money—they can't use it twice. They've given it to us; it's been used to finance our big current account deficit. So the resources they have available to support these kinds of rescue operations are not the full two trillion, but it's the additional surpluses that they are generating in the global market. And those are still significant, running about $300 billion a year. So those incremental funds could be put to work in the form of buying equity in financial institutions to bolster their balance sheets, instead of buying treasury bills that allows the financing of the deficit.

But I think there's a misperception that they can redeploy the two trillion. We already have that money and we've already spent it.

Steve Weisman: There's a lot of anxiety about China among Americans and it hasn't turned out to be a major political issue in the election year. But how do you think the U.S. government has done over the last year in trying to improve relations with China on these economic issues?

Nicholas R. Lardy: Well, I think it's been a mixed picture. I think the strategic economic dialogue which was started by Treasury Secretary Paulson has established a very good framework for addressing a number of very, very important issues. Climate change, the currency, the rebalancing of China's economy would be just a few of the subjects that have been discussed. Food safety, product safety more generally certainly have been discussed. So it's provided a very good framework for getting much higher-level attention to these issues than otherwise would have been possible.

People debate how successful it has been in terms of results. There's been progress in some areas; in other areas, I think less progress has been made, but that's probably inevitable that you're going to have a mixed picture.

Steve Weisman: Would you expect and would you advocate that this dialogue be continued by the next president or even elevated?

Nicholas R. Lardy: I certainly think there's merit in continuing this dialogue because it is the highest-level dialogue that we have. It does involve the presidents on both sides for part of each dialogue. It's being managed by a Vice Premier on the Chinese side and by the Treasury Secretary on our side. It could be managed a Vice President, if there was an inclination to move in that direction. So it could be raised somewhat. But I do think the mechanism has advantages. We have lots of more specialized dialogues, but they tend to be in various specifically defined domains, they deal with a narrow range of topics. And this is the only dialogue that kind of cuts across a number of issues, brings people together on both sides from a wide variety of agencies, people with a wide of range of responsibilities, and I think there's a huge advantage in doing that.

Steve Weisman: Nicholas Lardy, thank you very much.

Nicholas R. Lardy: Thank you.