Comments on Lu Gang's Paper
"Prospects for promoting China's internal demand: Some issues calling for clarification"

By Geng Xiao
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This is a very informative paper which tries to explain China's current macro economic conditions and policies from a Chinese policy researcher's perspective. Mr. Lu attempts to answer three key questions.

Question 1: The global financial crisis has led to China's great efforts to stimulate investment. Would this prevent China from expanding domestic consumption?

Lu's Answer to question 1: The financial crisis has not changed China's long-term policy target of expanding domestic consumption.

My brief comment to Question 1: China's increased investment is certainly to increase China's future consumption. For the purpose of rebalancing the global economy after the global financial crisis, it is necessary for China's government to aggressively increase investment now since household consumption is largely endogenous and depends heavily on household income. Given China's high savings rate and very high return on investment, China can afford to have higher investment rate. Higher investment growth will sooner or later lead to higher income growth and high consumption rate in the future.

Question 2: China has enhanced its effort to expand domestic demand. Does this mean that a rebalancing between the economies of the US and China can be achieved in the near term?

Lu's Answer to Question 2: It is unrealistic to expect China to complete the mission of shifting its economic development mode in three or five years.

My brief comment to Question 2: I agree that it will take time to carry out structural reforms but I am optimistic that there are policy tools available to address the structural problems in the Chinese economy. I will discuss more on this later.

Question 3: Globally, there seems to be an upward trend of investment protectionism against the background of financial crisis. Will China change its policy of promoting outward FDI due to the need to expanding domestic demand?

Lu's Answer to Question 3: The Chinese government will continue to actively promote its "go global" strategy.

My brief comment to Question 3: I agree with Mr. Lu. It takes time and experiences to understand the international markets. Given China's huge foreign exchange reserves and net foreign asset position, China has to learn how to diversify its global investment. From the experiences of Japan, a volatile exchange rate, especially one directional move in the nominal exchange rate, would discourage outward FDI.

In the rest of my comments, I would like to discuss three more questions related to the global imbalance which Lu's paper attempts to address part of problems on the Chinese side.

Are we addressing the symptoms or the causes of the disease?

The standard explanation about the global economic imbalance has centered on the excessive American consumption beyond its savings on the one hand and excessive Chinese production beyond its own spending on the other hand. The policy implications are then simple: the U.S. should export and save more and China should import and spend more. The question is if this diagnosis is correct and good, why it is so hard for the two countries to implement them?

In my view, the distorted consumption/savings and distorted imports/exports in the two countries are only symptoms. Too much attention of the officials, scholars, and the public are distracted to the unfortunate symptoms of global imbalance and short-term policy fixings such as lowering interest rates and pressuring others to appreciating their currencies. The focus on short-term policies is however prone to dis-trust and protectionism, leading to less efforts in finding out the real causes and sustainable long-term solutions. There is a danger that we may waste the windows of opportunities created by the recent crisis for reforming some of the most seriously distorted structure in the domestic economies.

I would highlight at least two areas which seem to deserve more attention they are getting now: the first is the price of energy and related natural resources and the second is the price of money or capital.

Is the price of high-carbon-emission energy and nature resources too low and its change too volatile?

The existing high emission economic growth model in the industrialized economies and China are both rooted in explicit or implicit subsidies to high carbon emission activities through low prices in traditional energy sources, land, water, raw materials and agricultural products. Without raising and stabilizing the prices of the traditional high-carbon-emission energy, it would be impossible to cut the emission significantly for preventing climate change disasters.

In the industrialized economies, the low prices of energy over last few hundred years have led to the fulfillment of the modern industrial lifestyle of big house, big car, and excessive consumption.

In China, the subsidies to energy over the last few decades are hidden in many forms such as:

- competition among local governments in attracting foreign invested enterprises by offering cheap land;
- weak property rights infrastructures that encourage wasting of nature resource-related inputs in the manufacturing sector;
- rudimentary systems of environmental standards and their weak enforcement;
- a lack of social safety net which makes the true costs of labor look so low now but with hidden social liabilities in the future. These subsidies and distortions in China created a myth that China, a relatively poor country, is subsiding consumers in all of the rich countries around the world through low prices of Made-in-China exports. These subsidies to Chinese exports are ultimately subsidies to energy consumption, which are not sustainable.

How can the industrialized economies and China help each others in gradually reducing these structural subsidies to the use of high-carbon emission energy and resources? The industrialized economies have a lot to share with China on how to develop a market infrastructure for pricing the land, water, energy, and mineral resources. China can also share with the industrialized economies on how to have a happy lifestyle with very limited consumption of nature resources. In fact, China achieved green and sustainable growth in the period of agricultural civilization for thousands of years with the population as a main renewable input in the traditional agricultural economy.

The world should work together to freeze some of the high-carbon-emission energy sources so that the current prices of high-carbon-emission energy could go up. The rising energy price will help to support the research and development of cleaner energy as well as provide incentives for people not to waste energy. Shouldn't we use up our cleaner energy first when we see clearly our technological progress will make our use of the less clean energy sources (such as coal) much cleaner in the future? In my opinion, these reforms relating to the price of high-carbon-emission energy are more important than the efforts to set a cap on total emission, which is a result, not the root of the problem.

Is the money too cheap?

Cheap money or low interest rate has led to property and stock market bubbles in the US and other economies. The bubbles brought temporary capital gains that reduced American's savings and increased their consumption to a level beyond their sustainable income. This is well known now. What has been overlooked in the public discussion is that the same cheap money also flowed into China through foreign direct investment. When the cheap foreign money combined with cheap Chinese land, energy and nature resources, they created a huge over-capacity in China's manufacturing sector, driving down the prices of Made-in-China products. Hence, cheap energy and cheap money are important causes for the global imbalance.

The question is how can the price of capital be so low when we have so many unemployed people in both poor and rich countries? Why could not the unemployed people simply hire or borrow the cheap capital and create employment, profits and sustainable green economic growth? In the language of the textbook economics, why can not we simply put the surplus labor and surplus capital into a production function to generate more output and growth? Why the flood of money created by the government could not eliminate high unemployment during the current recession?

A simple answer is that we are not smart enough in creating sustainable employment. Clearly our markets are not smart enough. Otherwise we would not have the financial crisis and unemployment problem in the first place. Our governments are also very constrained in providing help when the markets failed. Instead of raising the price of energy and the price of money to reduce distortions in the markets, our governments are actually doing the opposite. China is making the energy cheaper and cheaper by building more and more coal-firing power plants. The U.S. is making capital cheaper and cheaper by providing more and more liquidity to the failing banks. Central banks in both countries like to reduce interest rates but are slow in raising them when bubbles are emerging in the property and financial markets. The zero interest rate policy of the US may be necessary for the American economy but is creating a huge problem of hot money flowing into China to bet on the more than eight percent of growth there compared to no growth at all in most of the OECD countries. We are in a globalized economy with global financial markets, but our monetary policy is set by the nation-state with little coordination.

Can the world work together to make the price of capital closer to its true value? The key is to find ways to use money wisely to create employment as the real reason that money is cheap lies in the fact that creating valuable and sustainable employment is difficult for both the markets and the governments.

After the global financial crisis, China was very successful in creating employment by using the common sense approach: simply to build more highways, railways, subways, and other related infrastructures that China will surely need for its urbanization in the near future. Can the U.S. learn something from this? Can the U.S. government invest more in some of the infrastructure projects such as airports and subways in cities like New York? If the American graduates have hard time to find job in the U.S. now, why does not the U.S. government hire them for a few years and send them to China to study Chinese and Chinese markets for developing American's future export markets there? In a family, in China or in the US, the wife can easily find work for the husband to do if he is "unemployed". Why can not the American government try to find some meaningful work for its unemployed people to do now before the markets can find them jobs?

In summary, if the markets fail to set the prices of energy and money right. Our governments have the responsibility to help to set them right.