China’s GDP: What it means and why it matters

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As a part of the Chief Economist Talks series, the OECD hosted Michael Pettis, Peking University and Carnegie-Tsinghua Center for Global Policy *on May 25, 2020. This blog presents the takeaways from his presentation. More information regarding the OECD’s Chief Economist Talks, including previous speakers, can be found here.*

On May 22nd, 2020, China announced that it would not set a GDP growth target for the first time in decades, given the uncertainty spurred by the COVID-19 pandemic. Understanding the implications of this decision requires unpacking what GDP represents in China and how it differs from other countries. This distinction reveals some of the forces that underlie China’s growth and highlights the challenges the country faces going forward.

Peculiarities of GDP in China

There are three issues regarding GDP in China.

The first is the extent to which GDP is a good proxy of real economic value, the crux of the argument being that not all value-generating activities are included in the calculation of GDP and not all activities included in GDP generate value. This is a problem common to all countries, but it may be particularly pronounced in China given its large share of non-productive public sector investment.

The second is the concern regarding the accuracy and honesty of China's GDP statistics. However, while there may be some smoothing of volatility, the statistics likely follow generally accepted rules for GDP calculation.

The third issue, and the distinguishing feature of China, is that GDP is not an indicator of output, but rather an input. Unlike most other countries, China's GDP is predetermined by its GDP growth target. Entities in China, including local governments, organise their production and stimulate the economic activity needed to meet this target. This explains why China always achieves its growth target (plus or minus a few tenths of a percentage point) and why GDP no longer functions as a measure of economic performance for China, but instead reflects the intention of its government.

Conditions for using GDP as an input

Any country is theoretically capable of guiding its GDP in the same way as China under three conditions.

First, it must have high debt capacity and the willingness to use it. In China, the economic activity needed to meet the GDP growth target is funded through borrowing. High debt is not inherently problematic (nor is it unique to China) if it funds productive investments that generate their own debt-servicing capacity. However, when it is used to fund non-productive activities (e.g. under-occupied real estate developments), as is the case in China, borrowing increases the debt burden. This reveals the second condition needed for a country to mechanically meet its GDP growth target: no hard budget constraint limiting entities from engaging in value-destroying economic activity every year.

Thirdly, there is an accounting condition. In China, debt used to fund non-productive investments (i.e. bad debt) is not written down and the losses from this investment are not formally recognised. As an illustrative example, consider two Chinas: both invest in non-productive real estate. Whereas China A, once it recognizes that it has made a bad investment, takes a full write-down on its asset, which reduces the value-added component of its GDP calculation, China B does not do so. This difference in reporting mechanics means that despite having the same economic reality, China B will have higher GDP than China A. While this allows China to meet any growth target it sets, it also means that its GDP overstates the health of the underlying economy (by the value of non-productive investment that is not written down).

Policy implications and COVID-19

If China’s debt capacity was unlimited, this dynamic could continue indefinitely. However, given a limit and since China’s borrowing does not fund investment that yields productivity gains necessary to service its debt costs, the debt-servicing costs must be allocated to some sector of the economy. For example, it could be allocated to households through inflation, to the rich through taxes, to the poor through wage suppression, and so on. This causes changes in behaviour, such as reduced investment from local businesses and diminished household consumption, which hurts China’s underlying economy.

A key policy question, then, is how to bring China’s debt burden under control. Doing so would require scaling down the public investment’s share of GDP, which would necessitate replacing this source of demand. While productive private sector investment could theoretically fill this gap, the private sector in China is more prone to disinvestment. Besides, it is unable to match the size of the public sector. Instead, China could boost consumption. Currently, China has a very low consumption rate and households account for a low-share of GDP. To rectify this, China would need to liquidate assets of local elites and transfer them to households. This, however, is politically challenging to implement. Until Beijing is able to push through this type of household transfer, China must rely on non-productive public investment, which increases the debt burden, and hence, places a limit on the underlying economic growth in China.

COVID-19 has not fundamentally altered anything in China. Rather, it has accelerated many of China’s underlying issues, including inequalities, trade imbalances and the debt burden. Official statistics indicate that China’s debt-to-GDP ratio increased from 239% at the end of 2018 to 245% at the end of 2019 (an increase of 6 percentage points); this year, under the most favourable conditions, this ratio can be expected to increase by 12-18 percentage points. This threatens China’s debt sustainability, effectively cutting its timeline to act by about two years. This is reflected in China’s decision to not set a GDP growth target, perhaps recognising the perils of its rising debt.

References

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