Western mistakes, remade in China

By Adair Turner

April 16, 2016 – *Project Syndicate*

The Chinese economy faces an enormously challenging transition. To achieve its goal of joining the world's high-income countries, the government has rightly urged a "decisive role for the market." But, while market competition works well in many sectors, banking is different. Indeed, over the last seven years, China's reliance on bank-based capital allocation has led to the same mistakes that caused the 2008 financial crisis in the advanced economies.

Rapid GDP growth requires high savings and investment, and high savings almost never result from free consumer choice. States can directly finance investment, but bank credit creation can achieve the same effect. As Friedrich Hayek put it in 1925, rapid capitalist growth depended on "the 'forced savings' effected by the extension of additional bank credit."

Japan and South Korea both used bank credit to finance high levels of investment in their periods of rapid growth. South Korea's nationalized banks directly funded export-oriented companies. In Japan, private banks were "guided" toward the tradable sector.

But while governments dictated broad sectoral priorities, banks decided the firm-by-firm allocation and extended credit via loan contracts, which imposed financial discipline. If Japan and South Korea had instead used direct government finance, capital allocation would almost certainly have been worse.

But while Japan's banking system helped drive stunning post-war growth, its credit-fueled real-estate boom in the 1980s and subsequent bust led to 25 years of slow growth and creeping deflation. The global financial crisis of 2008 and subsequent post-crisis malaise replicated the Japanese experience in many other countries.

As economies get richer, they become more real-estate intensive. That is partly because people devote a rising share of their income to competing for property in more attractive locations, and partly because in service-intensive economies, high-value-added activities and talent cluster in dominant cities.

But whatever the causes, the facts are clear. The rising value of real estate is by far the most important reason for the increase in wealth-to-income ratios that Thomas Piketty discussed in his book *Capital in the Twenty-First Century*. And, as an excellent recent empirical study shows, "by 2007, banks in most countries had turned primarily into real estate lenders."

This trend undermines the assumption that banks allocate capital efficiently. If desirable real estate is in scarce supply, credit creation and allocation can at times be driven not by rational analysis of alternative investment projects, but by self-reinforcing cycles in which more credit drives asset prices higher, which then sustains expectations of further rises, leading to more borrowing demand and credit supply. As the Bank for International Settlements has shown, credit and real-estate cycles are not just part of the story of financial instability in advanced economies; they are almost the entire story.

It is a story that China has repeated since 2009. To offset falling export demand in the wake of the global financial crisis, the government unleashed an enormous wave of investment in railways, urban infrastructure, and property. The authorities could have used public expenditure to finance this construction boom, borrowing or printing the money required. Instead, officials opted for a bank credit boom, which caused the debt-to-GDP ratio to rise from around 150% in 2008 to 250% by 2014.

In theory, bank-led resource allocation should have ensured that only viable projects were financed. In fact, much investment has been wasted: Huge new apartment blocks in some third-tier cities will never be occupied, and heavy-industry sectors such as steel and cement now suffer from severe overcapacity. With many firms in those sectors now relying on new loans to cover operating losses, large bad debts are inevitable.

Some of China's problems stem from the fact that the banking system is primarily state-owned, with close links between local governments and provincial lenders, in particular, undermining disciplined credit assessment. But we know that privately owned banks also make huge mistakes.

Ireland's banking system was entirely private, but the country's pre-crisis credit and real-estate boom left it with some 20,000 homes on "ghost estates," all of which will likely be demolished, their construction an utter waste. With China's population 300 times that of Ireland, the equivalent number there would be six million.

China, moreover, is a far more real-estate-focused economy than Japan or South Korea were at similar stages of income growth. Whereas Japan and South Korea focused on industrialization, China has urbanization as an overt objective, and its system of financing local government – with cities dependent on land sales to cover their budgets – has intensified the bias toward real-estate development. According to the International Monetary Fund, China already has more square meters *per capita* of urban residential real estate than Japan or South Korea.

China has already repeated the mistakes that led to Japan's post-1990 slowdown and to sustained post-2008 economic malaise in many other advanced economies. Like them, it must develop regulatory approaches that offset the banking system's bias toward excessive real-estate finance.

But the authorities also must address the enormous debts already accumulated, by using fiscal resources to fund bank recapitalization. Meanwhile, increased fiscal expenditure on social welfare could help reduce high household savings rates, supporting the necessary shift to a more consumption-driven economy.

And yet, despite talk at the Shanghai G20 meeting in February about fiscal stimulus, China's latest plans are for a 2016 fiscal deficit of 3%, no higher than in 2015. Officials seem worried that a larger public role might undermine financial discipline; in other words, like the advanced economies before 2008, they assume that dangers to efficiency and stability result solely from an overactive state.

In fact, while states can be inefficient and prone to inflationary temptations, private banking systems can also allocate capital badly, sustaining credit cycles that leave behind profound economic malaise. The advanced economies and China together need to develop theories and policies which recognize that banks are different, and that the case for free-market competition – valid in other economic sectors – does not apply to them.

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