Examining China's Economy: A Conversation with Atlanta Fed Researchers

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Charles Davidson: *Welcome to another monthly* Economy Matters *podcast. I'm Charles Davidson, staff writer with* Economy Matters*, and today we're visiting with two of the Atlanta Fed's research economists, Tao Zha and Patrick Higgins. Tao is executive director of the Center for Quantitative Economic Research, and Pat is an associate policy adviser and economist. Pat, Tao: welcome.*

Tao Zha: Thank you.

Patrick Higgins: Welcome.

Davidson: *We're going to talk today about research on China's economy that Tao, Pat, and another of our economists at the Atlanta Fed, Dan Waggoner, have been conducting. Among other work, they have built an ongoing series of data on China's macroeconomy, and devised a tool to forecast GDP [gross domestic product] growth and inflation in China.*

Pat Higgins, associate policy adviser and economist, and Tao Zha, research center executive director, at the recording of the podcast episode.

So guys, let's jump into that: first off, why is the Atlanta Fed interested in China's economy, and what are the broad objectives of this research that you guys are conducting?

Zha: The Atlanta Fed is interested in China's economy because, obviously, China has been the second-largest economy in the world, and [is] moving towards [becoming] the largest one sometime down the road, in the future. So its economic situation and its policy will have profound implications for other countries, especially for the U.S., so that's why the Atlanta Fed is interested, or why anyone should be interested.

And the broad objective of this research is for us to understand China in a much deeper way, in the sense that quantitative analysis of their economy and how that will impact U.S. policymaking—and that's our broad objective. We really want to do our best job to quantify the interactions between China's economy and the rest of the world.

Higgins: I would add to that: a lot of the importance is trying to build a dataset that's kind of comparable to the United States in terms of their macroeconomic aggregates, and then comparing. A lot of analysis of China hasn't done the sort of business-cycle analysis like is done with developed economies, so we want to introduce that sort of analysis as well.

Davidson: *Well, guys, I know you all have devised a tool to forecast GDP growth and inflation in China, and that tool appears to be more accurate than others that are out there. Is this one of the more important milestones from this work thus far, and are there other key findings or accomplishments of this* *research program?*

Higgins: Yeah, I think one key finding for the paper we found that the models actually did not as well as professional forecasters in forecasting China's real GDP growth. But they did better or at least as well in forecasting their inflation. And I think our hypothesis was that the model's obviously not going to know the announced GDP growth targets like private forecasters will. So if China says it wants to hit 6.5 to 7 percent growth, it's been able to do that, and professional forecasters are going to know that. But for inflation, the government has a lot less control over that—it's less able to hit that target, and the model does a pretty good job of forecasting that.

Davidson: *Now why is that important to us? Why do we want to know more about that?*

Higgins: Well, in terms of world growth, China is responsible for about 35 to 40 percent of world GDP growth, whereas the U.S. is responsible for about 20 percent or less. So the big driver of the world economy in terms of growth is China. So if world growth is important for U.S. growth, knowing how fast China's going to grow is really important.

Davidson: *Are there surprises that you guys have discovered about China's economy—anything you didn't expect to find?*

Zha: One of the most important discoveries we found is that policy in China plays a very, very important role, because a lot of people are talking about "productivity matters, innovation matters"...yes, undoubtedly, those factors matter, too. But we found that the particular policy environment that the Chinese government has been adopting is very, very important.

For example, one of the policies they have is trying to steer the economy, moving towards more investment, so their credit policy, monetary policy are trying to coordinate in such a way to move the economy towards a more investment-driven economy. And those kinds of policy initiatives really matter for China's growth, in addition to productivity and innovation.

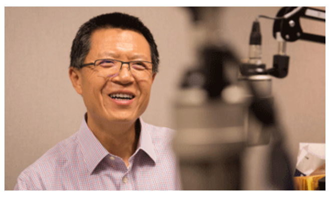
Davidson: *Right, right. What are some of the keys to China's rapid economic growth? We've all heard a lot about the explosive growth of the Chinese economy—Pat, you referenced that earlier—and it's slowed more recently. What are some of the reasons for that?*

Higgins: Yeah, one thing is their industrial sector—as the world economy has slowed, and there's less demand for Chinese goods, their industrial sector has slowed down quite a bit. Investment was responsible for a lot of their growth from about 2000 or so to 2011 or '12, and that's fallen off quite a bit. So they've been transitioning more to a service sector and consumer-driven economy, and that transition...there's been some slowing in their growth in that transition.

Davidson: *Tao, anything to add there?*

Zha: I would just add—and I agree with Pat—and I would add that how what has happened, as Pat pointed out, is really a deliberate policy initiative because the Chinese government wanted to have more investment, because they know that's the driving engine. This is in addition to innovation and productivity, because they just want to add physical capital stock: building infrastructure, and producing steel and ships and real estate. So their whole goal, rapid economic growth, depends on investment. And the Chinese people are willing to save to support that kind of investment.

Davidson: *A sort of very general question here: to what extent does the Chinese government still control the economy. It's still largely a planned economy, is that correct, Tao, or is that too broad a statement?*



Zha: I think the planned part is quite substantial, and I would call that the "heavy hand of government." And that hand is quite heavy, because, if you really think about it, the four largest banks—which are very important to channel credit to the nonfinancial sector, for China's growth—are owned by the government, and other large commercial banks are heavily influenced by the government as well. So if you think about it, that's a big chunk of finance under control of the government, including telecommunications and other heavy industries.

So I don't see there is any let-up of government continuing to influence the economy...or planning the economy, as you said. Every year, the National People's Congress meets to discuss what the plan should be, and all the local government officials have to sign off on that. This is a big effort for them to continue that path. So, even down the road, there'll be more liberalizations of financial markets. The market probably will play more roles in that. I don't think it's like in the U.S.—I think China will continue to have heavy influence from the government, and the planned element there will be there for quite some time.

Davidson: *Well, you may have just answered this question, to a degree, but if there were a couple of data points, or maybe just broad truths, that Americans who are interested in economics should know about China as a global economic player, what would you point to?*

Higgins: The Chinese economy is about 60 percent to two-thirds as large as the U.S., I guess by even purchasing power parity standards, which is what the World Bank—they put that together, where you value how many goods you could actually buy. I think [if you] value those equivalently, they're actually slightly larger than the U.S. But if they grow at the rate they're continuing to grow at, they would catch the United States in about 10 to 15 years or so. But on per capita terms, they're still only about a seventh as large as the United States, so they're still a relatively poor country.

Davidson: *Right, that reflects our basically what we call standard of living.*

Higgins: Sure.

Davidson: *Often in the popular press, the media, the general conversation, there seems to be a fair bit of hand wringing about China's growing economic strength and influence, vis á vis the U.S. especially; should Americans worry about China being a stronger economy?*

Higgins: Yeah, it's a hard question to answer. They're certainly an important economy; but I think most people—at least, for policymakers if you're looking at short-run fluctuations—a big slowdown in Chinese growth wouldn't necessarily be good for the U.S. economy. Roughly a quarter of our imports are from China, and about 10 percent of our exports are to China—and those shares have been growing by multiples over the past 15 years. So there's definitely some integration between our economies that wouldn't be good in the short run if they slowed down dramatically, certainly.

Davidson: *Right. So our interests are aligned in some important ways.*

Higgins: Sure.

Davidson: *Where do you guys see your work on China headed? What's to come?*

Zha: There are many important works ahead, and data—of course, we're going to continue to work on data, as Pat pointed out, and that's very important. I think it's a good public service for people to make an effort to make the data more transparent and more standard, for us to really understand China's economy.

And beyond that, I think one of the vacuums in the research on China is in talking about Chinese government policy and how that policy affects the Chinese economy and also the rest of the world. And there's a lot of research done about productivity and innovations, more on the micro level, but the macro level has been very scarce in terms of research output.

So that's where we're heading for—we wanted to see how policies work. And either they change and move to a new policy, or they want to have existing policies but under different fundamentals, a different environment. No matter what the situation would be, it would be very important to analyze those policies. And the Chinese government actually needs that advice too, because they want to know if they want to conduct some different policies what the impact would be, and they would like to know more research products in that area.

Davidson: *How much research like this is going on in China?*

Zha: They have a lot of research in Chinese journals, and the volume is tremendous, and many discussions on policy issues as well. But what's lacking is more rigorous, empirical work, and quantifying the effects. The precision and the rigor are what were required here.

Davidson: *So the policymakers in China are open to this; they encourage this kind of inquiry?*

Zha: Indeed. In fact, [Chinese] President Xi Jinping even says that they like to have first-rate economists thinking about those issues, so they are keenly aware of these development areas.

Davidson: *Right, well very interesting stuff, and I'm sure we'll talk further about all this as you guys keep up this good work. Thank you both for your time, it was an interesting conversation and I enjoyed it. And thank you folks for listening, and please return next month for another* Economy Matters *podcast.*

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