China's Rebalancing Act

Shoppers and pedestrians outside a department store in Wanfujing District, Beijing.

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IN THE past 20 years, China has added about $2 trillion to world GDP, created 120 million new jobs, and pulled 400 million people out of poverty. These are big numbers—equivalent to adding a country of the economic size of Portugal every year; creating as many new jobs each year as the total number of people employed in Australia; and eradicating poverty in Ethiopia, Nigeria, Tanzania, and Zambia combined. In recent years, China has grown more than 10 percent annually while keeping inflation below 3 percent. Today, it is the fourth largest economy in the world and the third largest trading nation.

Despite these remarkable achievements, there is growing unease within China and abroad about the state of its economy. At the National People's Congress this March, Premier Wen Jiabao cautioned, "the biggest problem with China's economy is that the growth is unstable, unbalanced, uncoordinated, and unsustainable." More generally, the question is whether the pace of growth is sustainable or whether the imbalances in the economy might slow growth, perhaps significantly. And this is why China's policymakers are looking to rebalance the economy to rely less on exports and investment and more on consumption as the source of growth.

What are the underlying causes of these imbalances and how should they be addressed? Those are critical questions not only for China but also for much of the rest of the world, whose prosperity is linked to China. For as China has grown, its economic impact on many countries has magnified, whether through its large trade imbalances, exchange rate issues, or its large and growing need for resources and food. There are many suggestions about the policies China should pursue to rebalance its economy—and some even argue that the rebalancing will occur "naturally" as a result of market forces (see "Solving China's Rebalancing Puzzle" on page 32). We believe that a rebalancing will not happen on its own and lean toward an effort that relies on monetary policy, price liberalization, financial market reform, and changes in government expenditure policies.

China's economic miracle may be at risk unless the country relies more on domestic consumption

How it began

China's liberalization is usually separated into three phases—the reforms of 1978, 1984, and 1994—each of which further opened the economy. The 1994 reforms had three prongs: the unification of the official and market exchange rates and the removal of restrictions on payments for trading goods, services, and income; the opening of the export sector to foreign direct investment; and the reform of the state-owned enterprises (SOEs). The first two changes turned the export sector into a powerful engine of growth, and the third unleashed domestic entrepreneurship.

Foreign enterprises, on their own and in joint ventures, used China's cheap but skilled labor to convert the coastline into the "world's workshop" and a critical node in the global supply chain. Meanwhile, domestic enterprises, relieved of costly social responsibilities and not required to share profits with the government, began to invest in new technologies, expand rapidly, and seek out new markets. Domestic private sector firms also developed. A plethora of incentives from both the central and the local governments—in the form of tax breaks, cheap land, and low utility prices—helped to keep production costs low and raise profits to be reinvested in further expansion.

With capital controls and an underdeveloped capital market limiting investment choices, China's large pool of savings provided these enterprises with a captive and cheap source of financing through a state-controlled banking system. And with this, China began an economic expansion of unprecedented pace driven by investment and exports. But consumption growth, in particular, could not keep pace with the capacity created by rapid investment. As a result, the share of investment in GDP rose, while that of consumption declined, with the difference picked up by a rising trade surplus (see Chart 1).

Rising growth, mounting imbalances

The concern is that China's rapid growth could slow, perhaps even sharply, if the continued expansion of capacity eventually leads to price declines that reduce profits, increase loan defaults, and undermine investor confidence. As the imbalances grow, so does the probability of such a development. If the global economy slows at the same time and competition from other countries rises, Chinese firms would find it that much more difficult to sell their products abroad without deep price cuts. Moreover, the risk of rising protectionism in China's trading partner countries could worsen the situation.

But didn't many of today's successful economies sustain such a development strategy for some time? Indeed, an export-based growth strategy backed by large domestic savings and investment was the right path for China in the early 1990s. And it has been remarkably successful. That said, much has changed since 1990, when China was a small economy just starting to open up, importing sophisticated inputs and assembling them into consumer goods for the West. Today this assembly-line business makes up less than 10 percent of China's $250 billion trade surplus. Instead, China's exports have branched into new and more sophisticated products with a growing proportion of domestically made inputs. China also has become a dominant player in many markets. While it was relatively easy to expand market share before, further expansion will likely require Chinese firms to cut prices. If the price cuts needed to sell the created capacity turn out to be deep, many of today's investments could become unviable, turning into tomorrow's loan defaults.

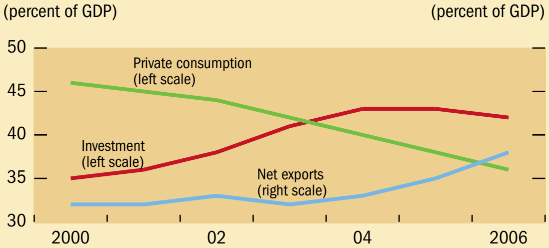
Why is investment high? There is no big mystery here. Profits of Chinese companies have risen sharply over the past several years, suggesting that returns on investment are very attractive. In part this is because key input costs are low—including energy, utilities, land prices, and pollution control. But perhaps most important is the low cost of capital. Investment accounts for nearly 45 percent of China's GDP, and 90 percent of that is financed domestically (the national saving rate is 55 percent of GDP). Foreign direct investment accounts for less than 5 percent of GDP. Domestic bank lending and reinvested earnings of firms share the bulk of the financing needs. Bank lending rates are low because of low deposit rates set by the government.

Since the enterprise reform, the government has not sought dividends from SOEs, not even from those that are listed on the stock exchange and pay dividends to their private shareholders. For these enterprises, profits either are reinvested or sit in low-earning deposit accounts. Rising corporate saving has been the main reason that China's overall savings have gone up. Corporate savings roughly equal household savings—at about 23–24 percent of GDP. Low bank lending rates and retained earnings have kept the cost of investment funds low. Whereas real GDP growth in China has averaged about 10 percent, the real cost of investment has hovered at about 1–2 percent. In advanced economies that gap is negligible. In most emerging

Chart 1

Out of balance

Consumption has not kept up with capacity increases, giving rise to a growing trade surplus.



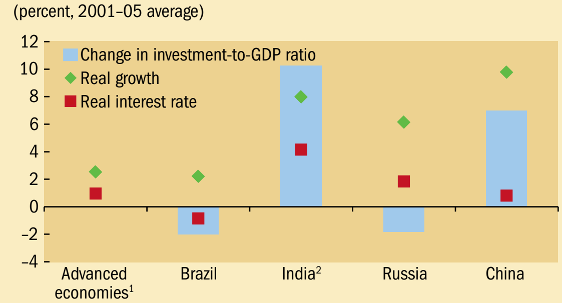
Sources: CEIC Data Co. Ltd.; Chinese authorities; and IMF staff estimates.

Chart 2

Strong incentive to invest

The wide gap between investment cost and real GDP growth explains the big investment share of total output.

(percent, 2001–05 average)



Sources: IMF, *World Economic Outlook*, and IMF staff estimates.
[1]As defined in the *World Economic Outlook*.
[2]Average of 2004–05.

Consumption levels lag badly

Consumption in China is substantially lower than in other major economies.
(percent of 2004 GDP)

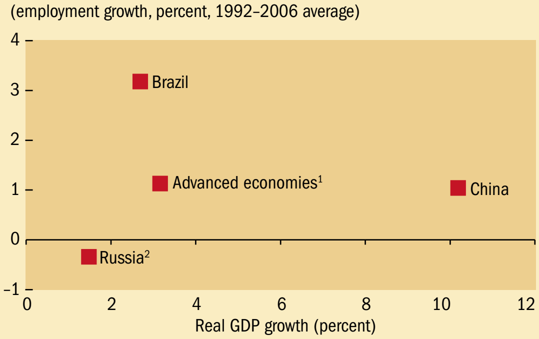
	Household disposable income	Taxes on personal income[1]	Household consumption/ disposable income	Labor income	Personal consumption	Government consumption on health and education	Adjusted consumption[2]
United States	74	9	95	57	70	10	80
United Kingdom	66	10	98	56	65	12	77
Italy	67	...	90	42	60	12	72
Australia	58	12	103	49	60	11	71
India	84	2	76	...	67	4	70
Germany	66	9	88	51	57	6	63
Canada	58	12	96	50	56	7	63
France	62	8	90	52	56	6	62
Japan	59	8	96	51	57	5	61
Korea	54	3	95	44	51	5	56
China	60	1	69	56	41	3	44

Sources: OECD; CEIC Data Company Ltd; and IMF staff estimates.
Note: ... denotes not available.
[1]2003 figures.
[2]Personal consumption and government consumption on health and education.

market economies it is positive, but in none is it as wide as in China (see Chart 2). It is not surprising then that investment growth is so much faster in China and that investment's share of GDP is one of the highest in the world.

The cost of capital is not just low; it has fallen relative to wages, despite China's abundant labor supply. As a result, as economic theory predicts, production has been skewed increasingly toward capital-intensive processes, and job creation has slowed. In most countries, 3–4 percent GDP growth is associated with 2–3 percent employment growth, but in China, 10 percent GDP growth is generating only about 1 percent employment growth (see Chart 3). In addition, the undervalued exchange rate and widely held expectations among investors that the currency will appreciate only gradually have biased investment toward exports and import substitution, adding to the rise in the trade surplus.

Chart 3
Too few jobs
Despite soaring GDP growth, job creation has been slow.
(employment growth, percent, 1992–2006 average)



Sources: IMF, *World Economic Outlook*, and IMF staff estimates.
[1]As defined in the *World Economic Outlook*.
[2]1993–2006 average.

Why is consumption low? Although consumption has grown at a real rate of 8 percent since the early 1990s, it has lagged GDP growth. Personal consumption's share of GDP has fallen by more than 12 percentage points, to about 40 percent, one of the lowest levels in the world (see table). While household savings in China are high and their rate has increased somewhat in recent years, this can explain only about 1 percentage point of the drop. Nearly all the decline is attributable to a falling share of national income going to households, including wages, investment income, and government transfers. Many countries have seen their wage share decline. But, in most countries, overall household income has held up reasonably well because rising dividend and interest income have offset the falling wage share. In China, though, household investment income has declined from more than 6 percent of GDP in the mid-1990s to less than 2 percent today, mainly because of low deposit rates and limited household equity ownership (directly or through institutional investors). Moreover, in most countries, profits of SOEs are transferred to the government, which uses them to provide consumption goods, such as health care and education, and income transfers to households. But in China the government receives no dividends, and transfers to households and public spending on health and education have declined.

Why rebalancing won't happen on its own

The way to address these imbalances seems straightforward: switch from investment and exports as the main drivers of growth to consumption. Some analysts question whether there is a major problem and suggest that the normal business cycle will rebalance the economy. During upturns, firms invest and expand, increasing the demand for resources, such as capital and labor, these analysts say. That raises input costs, driving down profits and slowing investment. Less productive firms exit, economic growth slows, and prices stabilize.

In China's case, however, that argument is flawed. Business cycles usually occur in more advanced economies in which markets are well developed and prices provide early signals, allowing firms and households to adjust smoothly. In China, markets are not developed and prices do not provide a true reflection of underlying supply and demand conditions in key markets. Instead they are influenced, to varying degrees, by the government. Consequently, rebalancing requires active involvement by the government in the form of policy changes and reforms. What are those needed policy changes and reforms? There are four principal steps:

"The obvious way out is to simultaneously raise the floor on lending rates, lift the ceiling on deposit rates, and allow the exchange rate to appreciate more quickly."

First, raise the cost of capital. In the immediate future, interest rates and the exchange rate hold the key to curbing rapid investment growth and the associated rise in bank lending. Curbing investment has been the main goal of macroeconomic policy over most of the past three years. The Chinese authorities have also tried to control investment directly using a combination of administrative measures and "guided" bank lending, but these have not provided a lasting solution. China must increase its reliance on monetary policy to curb investment and credit growth by raising the cost of capital, the main reason investment is growing so rapidly. But the authorities fear that if the currency is tightly managed, increases in interest rates will encourage capital inflows that will add liquidity to the banking system, requiring further interest rate hikes to absorb it. China's government not only imposes a ceiling on deposit rates, it also sets a floor on lending rates and tightly manages the exchange rate, even after the changes made to the exchange rate regime in 2005.

The obvious way out is to simultaneously raise the floor on lending rates, lift the ceiling on deposit rates, and allow the exchange rate to appreciate more quickly. This will provide the room monetary tightening needs to be effective. Not only will the financial cost of capital increase, but, over the medium term, a stronger currency will help curb investments in the export and import-substituting sectors, while raising household incomes. The objective for economic policy should be that both interest rates and the exchange rate are increasingly determined by the market, so that the right price signals are provided to investors and households.

Second, liberalize prices. Reducing investment growth will require more than just monetary tightening. Other key prices in the economy also need to reflect market conditions and the underlying resource costs. In the past few years, the government has begun to raise the price of industrial land, power, and gasoline, and, importantly, to introduce stricter environmental standards and better enforce pollution controls. The government's goal of cutting energy use per unit of GDP by 20 percent over the next five years should help not only improve energy efficiency and reduce pollution, but also curb investment growth by raising business costs.

On the tax front, the government is unifying the enterprise income tax rate but still must cut tax and other incentives for investment that have proliferated over the past two decades, particularly at the local level. Raising the cost of capital also requires the government to exercise better corporate governance over SOEs, including asking profitable firms to transfer dividends to the budget. A pilot program is planned in which some SOEs would pay dividends to the budget in 2008, the first time since 1994. This is a step in the right direction, but the program needs to be expanded, especially to cover listed companies, which should pay the government the same dividends they pay to their private shareholders.

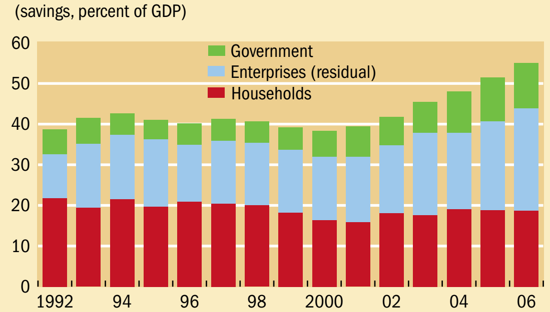
Third, reform financial markets. While weak corporate governance by the government has allowed SOEs to accumulate large savings, private enterprises, especially the small and medium-scale ones, have done the same because poor financial intermediation has limited their access to bank credit (Aziz, 2006). In the early 2000s, China embarked on an ambitious bank reform program and has made substantial progress in cleaning up nonperforming loans, recapitalizing banks, and opening the sector to foreign participation and competition. But, as a result, banks turned conservative—because of their weak internal risk-management and risk-pricing systems—and have continued to direct most credit to large cash-rich SOEs at the expense of private firms and households. Because capital markets—bond and equity—are also weak, they have not been an alternative source of financing for firms or savings for households. Firms have instead had to rely on internal savings for investment, and consumers have done the same for almost all large purchases—education, health care,

Chart 4

A need for financial reform

Private firms and households are increasingly turning to savings for investment and major purchases.

(savings, percent of GDP)



Sources: CEIC; Chinese authorities; and IMF staff estimates.

pensions, housing, and durable goods (see Chart 4) (Aziz and Cui, 2007). Greater access to credit and a broader range of instruments to raise funds would reduce the incentives of firms to hold large savings, and better access to credit, insurance, and private pensions would diminish household saving and boost consumption.

Better financial intermediation has thus become the government's top priority. The authorities are pushing for further improvements in the banks' commercial operations, internal controls, and governance. They should also lift the cap on deposit rates, which would not only help push up the cost of capital but also allow smaller and more aggressive banks to compete better against large state-owned banks and provide an incentive for big banks to expand credit to small and medium-scale enterprises. China is also looking to expand its other financial markets, especially bond and equity markets. However, continued government control over bond and equity issuance is a serious impediment to these markets. Raising household consumption requires not only increasing the household share of national income but also reducing the uncertainties that have kept precautionary savings high. For the first, a key factor is increasing households' investment income—through higher deposit rates and greater participation in the equity market, and directly and indirectly through expanded mutual and pension funds. Equity market reforms of the past few years have revitalized a languishing stock market, but the supply of equities needs to be increased.

Fourth, shift government expenditures. The government has another important role in this rebalancing exercise: improving the provision of key social services, especially education, health care, and pensions (see Chart 5). Reducing the uncertainties surrounding their provision will substantially diminish the strong precautionary saving motive and give households the confidence to raise their consumption. In the 1994 SOE reforms, the provision of health care, education, and pensions was transferred from companies to local governments. However, in general, local governments were not provided with adequate resources to discharge these new responsibilities. Consequently, households have had to bear an increasing portion of the costs of health care and education. Chinese households pay about 80 percent of health care costs out of their own pockets, one of the highest proportions in the world. They also face considerable uncertainty about pensions, because reforms in this area have not produced a new, viable pension system, although China's one-child policy has intensified the aging of the population and raised the need to save for old age. The government has increased spending for education and health care in recent budgets, but the increases have been limited. In essence, households have self-insured against uncertainties associated with pensions, health care, and education. As a result, they have saved significantly more than they would have were these risks pooled socially.

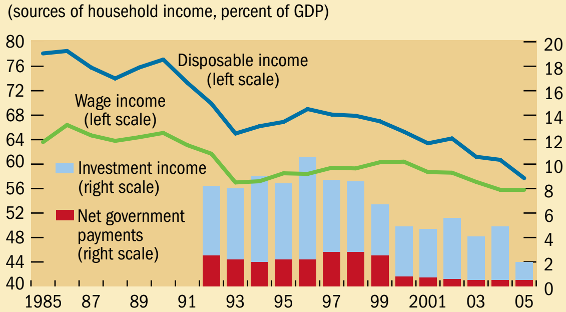
"The current high growth and low inflation in China and a benign world economy may give the false impression that China has time on its side in implementing these reforms."

Chart 5

Resorting to self-reliance

Government payments to households for health care, education, and pensions have been low and uncertain.

(sources of household income, percent of GDP)



Sources: CEIC; Chinese authorities; and IMF staff estimates.

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Rather than provide quick fixes, the government has rightly decided to rebalance the economy by implementing fundamental reforms along several dimensions to shift the economy's heavy reliance on investment and exports toward consumption. China has already made progress on many of them, and most analysts agree on the basic elements of the strategy. However, there is a concern that the current high growth and low inflation in China and a benign world economy may give the false impression that China has time on its side in implementing these reforms. The reality could be different. Unchecked, the imbalances will continue to grow and, with them, the rising probability of a large correction will become a major threat to the country's economic growth and stability. ■

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