Economic Rebalancing in China

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The Imperative to Rebalance

For the past several years China's top leadership has repeatedly described the country's current economic model as "uncoordinated, unsteady, imbalanced, and unsustainable." This language is in sharp contrast to what has been a decade of apparent success: high-speed economic growth and emergence into the ranks of middle-income countries. What accounts for this disparity between rhetoric and record? Chinese policymakers have correctly assessed that the country's economic growth over the past decade has been based on superelevated levels of investment and systematic suppression of private consumption. The resulting capital-intensive growth model has not generated adequate gains in consumption and employment and instead has built up significant distortions in the economy.

The longer these distortions accumulate, the greater the risk that the Chinese economy will face a sharp and wrenching correction, because overinvestment leads to unsustainable asset bubbles and large amounts of misallocated capital. China needs a different growth model for the next decade to sustain moderately fast growth. Chinese policymakers' gloomy rhetoric on the economy, therefore, is a justified acknowledgment that while economic growth over the past decade may have been fast, it has not been very healthy. The desire to move away from the excesses of the past decade and put the economy on a more sustainable growth path is the core objective of economic rebalancing.

The task of economic rebalancing is likely to demand much of the energy and attention of the new Xi Jinping–Li Keqiang administration. Rebalancing entails large changes in fundamental economic policies, such as removing lingering price controls and opening up the closed financial system. It will also bring about a shift away from the economic winners of the past decade, namely manufacturers and property developers, towards private consumers and the service sector. While a more balanced economic model will deliver more sustainable economic growth, it also requires a change in traditional modes of economic policymaking. Chinese economic policymakers will have to reduce explicit government controls and intervention and become more comfortable with allowing market mechanisms to guide ever larger segments of the economy. Despite these challenges, economic rebalancing is eminently achievable and should be tackled sooner rather than later.

The Progress of Economic Rebalancing in China

The best indicators for economic rebalancing come in the form of yearly GDP expenditure data. This data, usually released in March, shows the share of GDP attributable to consumption, investment and net exports. This data shows that dramatic economic imbalances grew rapidly in China through most of the 2000s, plateauing at high levels over the past two years. The expenditure data for 2013 has not yet been released, but it is likely to show little to no change in the super-elevated level of investment as a share of GDP. Between annual updates, there are several more high frequency updates that can be used to monitor the progress of economic rebalancing in China.

Urban Disposable Income Growing Faster than GDP: If disposable income is growing faster than GDP, absent an increase in the savings rate, this will lead to a rising share of consumption. Disposable income growth has outpaced GDP for the past year, a positive sign for economic rebalancing. It remains to be seen whether this will continue if GDP growth accelerates in 2013.

Positive Real Interest Rates on Deposits: Positive real interest rates on bank deposits are critically important for economic rebalancing. The on-average negative real interest rates over the past decade have been a blow to household income and wealth and served as the catalyst for speculative investment bubbles in the real estate market. Keeping interest rates above inflation for a significant period of time will not only boost incomes but also dissuade savers from taking their money out of the banks and speculating in the property market. Interest rates on deposits are currently positive in China, but only barely. Absent an increase in deposit rates, rising inflation is likely to turn real interest rates negative in 2013.

Residential Real Estate Investment Growing at a Slower Pace than GDP: Growth in residential real estate has been the key driver of economic growth over much of the past decade. This sector has grown unsustainably fast, reaching a point where China is investing 11 percent of GDP in residential real estate. For comparison, this is far more than either the United States or Spain invested at the height of their housing bubbles. The housing sector must come back down to reality along with all the sectors (steel, cement, etc.) that have grown unsustainably alongside it. The growth of residential real estate investment has slowed significantly from 2011 and is roughly advancing at the same pace as GDP growth. This is a neutral sign for economic rebalancing.

Loans to Small Enterprises Growing Faster than Total Enterprise Loans: Financing in China needs to shift away from large firms towards smaller firms. In the past, large firms have captured a disproportionate share of financing and forced smaller firms to rely on informal financing. Small firms are also a good proxy for private enterprises while large and medium firms have a much higher percentage of state-owned enterprises. Private firms have a higher return on assets than state-owned firms, almost twice as high in fact. Faster credit growth to private firms represents an improvement in the allocation of capital in China. Loans to small enterprises have grown faster than total enterprise loans for the past two years. While the gap between the two has narrowed in recent quarters, this is still a positive trend for economic rebalancing.

Growth of the Tertiary Sector Faster than the Secondary Sector: As a result of distortionary policies, industry has grown much faster in China than services for much of the past decade leaving China with a much less developed service industry than most countries at comparable levels of economic development. Faster growth in this area will be essential to rebalancing both because the service sector is more labor-intensive thus generating more employment and because the service sector pays higher wages on average. Fast service sector growth should help the wage share of GDP recover from the current low levels and thus boost consumption. Moreover, a rapidly growing service sector should reflect rebalancing because households increase their consumption of services (relative to goods) as their incomes grow. A slowdown in secondary growth over the course of 2012 has led it to grow at the same pace as the tertiary sector, a neutral indicator for economic rebalancing.

An examination of these indicators reveals that economic rebalancing is occurring in China, but at a suboptimal pace. Three out of five indicators listed above are positive, but only slightly so. The remaining two indicators are only neutral. The slow progress of rebalancing is at odds with the urgent rhetoric that policymakers use when describing the necessity of economic rebalancing. At the current pace, investment levels will remain super-elevated in China and consumption will remain depressed for at least the next decade.

Policies to Rebalance

The Interest Rate

Market-determined interest rates would lead to a rise in deposit rates, and banks would have to pass part of the costs of funds to borrowers in the form of lending rates that on average would be higher in real terms than has been the case in recent years. This would narrow the spread between the return on capital and the bank lending rate and therefore likely reduce China's extraordinarily high rate of investment, thus contributing to the policymakers' goal of reducing China's dependence on investment as a source of economic growth.

Higher deposit rates would also promote consumption through three distinct channels. First, higher deposit rates translate directly into more income for households. Second, higher deposit rates likely will lower the saving rate. This counterintuitive effect is due to severe financial repression, which has reduced the return available to savers. Because Chinese households are target savers, seeking a set amount of funds for emergencies and expenses, a lower deposit rate actually causes households to save at higher rates. Finally, higher lending rates lead to less capital intensive economic development resulting in more job creation, higher household income, and ultimately higher levels of household consumption.

The Exchange Rate

Although China's current account surplus has declined significantly from the peak levels of 2007–08, it is still large. Thus given China's persistent large current account surplus, a more market-based renminbi exchange rate almost certainly will lead to appreciation. This would contribute to economic rebalancing in two ways. First, by making exports more expensive and imports cheaper, currency appreciation would reduce the growth of exports and increase the growth of imports, cutting China's large global external surplus. On the domestic side, an appreciation of the currency would also decrease the profitability of the export-oriented manufacturing sector to the relative benefit of the service sector of the economy, which has languished since 2002. Secondly, a more flexible renminbi will mean less intervention in the foreign exchange market, a prerequisite for liberalizing interest rates.

China’s current account surplus in the first half of 2012 fell to only 2.1 percent of GDP, down dramatically from the 10.1 percent peak in 2007. This fall in the external surplus was made possible by the 30 percent appreciation in the real effective exchange rate since June 2005 and ongoing economic weakness in China’s major export markets, particularly Europe. This drop in the current account surplus in part explains the ability of the central bank to significantly reduce its intervention in China’s foreign exchange market in the first three quarters of 2012. Compared with an annual average of $435 billion in 2007–11, central bank intervention in the foreign exchange market dropped dramatically to only $64 billion in the first three quarters of 2012. Moreover, in 2012 there was substantial two-way movement in the value of the renminbi, and on some occasions the central bank actually appeared to be intervening in the market by selling foreign exchange to prevent a more sizeable depreciation of the currency. Thus in 2012 the value of the currency increasingly appeared to be determined by supply and demand in the market.

There are, however, several reasons to believe that significant intervention by the People’s Bank of China may not yet be a thing of the past. In the second half of 2011, economic fears brought about by a slowdown in the Chinese economy and the European crisis put downward pressure on the exchange rate and reduced the need for intervention. These concerns have since abated and thus the upward pressure on the exchange rate has returned. Related to the concerns, foreign currency deposits in domestic banks started increasing rapidly at the end of 2011 and the beginning of 2012 as Chinese corporations no longer felt compelled to immediately convert their overseas earnings into renminbi. These deposits increased by 58 percent ($149 billion) between 2011Q3 and 2012Q2, dramatically reducing the need for intervention by the central bank. But in the second half of 2012 the buildup of foreign currency deposits in the Chinese banking system abruptly stopped, as firms no longer expected much of a chance of renminbi depreciation.

The Price of Energy

The third price distortion that must be corrected is the cost of energy. Price controls on electricity, gasoline, and other liquid fuels act as an implicit subsidy to China’s industrial sector, which consumes two-thirds of energy production. This subsidy led to a more capital-intensive form of growth at the expense of the service sector. Removing these subsidies would help eliminate the incentives for overly capital-intensive growth and gradually increase the wage share of GDP as the more labor-intensive service sector develops more rapidly.

In both electricity and liquid fuels, the central government has been unwilling to pass along the full magnitude of cost increases and has instead imposed losses or low rates of return on state-owned enterprises. This makes energy-intensive industries, primarily manufacturers, more profitable than the service sector, leading to a rising share of investment in manufacturing and industry and a falling share of investment in services. In the 1980s and 1990s China’s service sector grew so rapidly that its share of GDP rose by an average of one percentage point per year, reaching 41.5 percent in 2002. With the onset of severe financial repression and other distortions in 2003, the service sector stagnated, growing by less than two percentage points between 2002 and 2011. China’s service sector share of the economy remains a full ten percentage points lower than what is typical for other emerging markets. Energy price distortions have resulted in a more capital-intensive growth path, which has rewarded capital at the expense of labor and led to a drop in the wage share of GDP. This distortion has lowered consumption levels and exacerbated income inequality.

Social Transfers and Reducing Income Inequality

The effort to unwind economic imbalances in China can be hastened by a greater emphasis on transfers and redistribution, which will bring down the saving rate and put more money in the hands of those most likely to consume. First, the Chinese government needs to continue to build out the social safety net in order to reduce precautionary saving by households. The lack of a safety net encourages households to save large amounts to deal with emergencies. A more robust social safety net will lessen the need for precautionary saving, lowering the household saving rate and increasing private consumption.

In addition to building out the social safety net, addressing China's high levels of income inequality will contribute to lowering the saving rate. The release of official Gini coefficient statistics was delayed for almost a decade as the National Bureau of Statistics worked to harmonize income measurement between rural and urban areas. In 2013, officials released revised annual Gini coefficients going back to 2003. The new data revealed that despite the populism of the Hu Jintao-Wen Jiabao administration, income inequality remained high throughout the last decade. During this period, the Gini coefficient hovered between .47 and .49, meaning that inequality in China is worse than in Russia and the United States and roughly on par with Nigeria and Mexico.

The most effective way to reduce inequality would be to adopt a more market-based interest rate, exchange rate, and energy prices, which will help increase the wage share of GDP and thereby reduce the enormous gains that have accrued to capital owners over the past decade and worsened inequality. There has been a considerable decline in the wage share of GDP since the emergence of severe economic distortions in 2003. A more balanced economic growth model should help the wage share of GDP to recover to levels more typical for emerging markets, around 55 percent. In addition, the government should increase the progressiveness of taxes in China, which relies too much on indirect, and therefore regressive, tax collection. Finally, further reforms to the hukou household registration system would reduce inequality between rural and urban areas and improve the living standards of China's migrant workers. The core of economic rebalancing is removing the distortions that pushed the economy in an unbalanced direction in the first place. These distortions are the misalignment of the fundamental prices, the exchange rate, interest rate, and price of energy. The lack of a social safety net and high levels of income inequality are important contributors to China's extremely high household saving rates. Bringing these prices back into alignment while increasing social transfers and adopting other polices to improve the distribution of income will boost consumption and establish more sustainable sources of economic growth for the future.

The Politics of Economic Rebalancing

A common refrain is that political reform in China is necessary to break the current deadlock on economic reform. This argument, advanced by many inside and outside China, states that the growing power of vested interests has strangled economic reform over the past decade. It follows that dramatic political reforms will cleanse policymaking of these roadblocks and open up space for economic reform to resume. Given the glacial pace of political reform in China, proponents of this viewpoint understandably are pessimistic about the prospects for further economic reform.

The political barrier to economic reform argument has some validity but is significantly overstated. In certain policy areas vested interests are strong and have successfully resisted reform. A clear example is state-owned enterprise dividends. Despite intense pressure by the Ministry of Finance and the State Council, dividends paid by state-owned enterprises starting in 2007 have increased only marginally and most are ultimately recycled back into the state sector. State-owned enterprises and their supervisory body, the State-Owned Asset Supervision and Administration Commission (SASAC), represent a vested interest that has successfully resisted needed reform. Other examples of vested interests resisting policy reforms include local governments ignoring central government housing purchase restrictions and resisting land acquisition reforms designed to increase compensation to peasants.

With respect to the key reforms needed for rebalancing, the case that vested interests are organized and able to resist reform is a lot less clear. The economic imperative for rebalancing is clear and shared widely amongst Chinese economists and policymakers. A brief survey of recent official economic policy documents is a testament to this point. In late 2010, the 12th Five-Year Plan (2011–15) included several core elements of rebalancing, including increasing consumption, interest rate liberalization, and opening the capital account. In September 2012, the People's Bank of China and China Banking Regulatory Commission released a financial reform plan calling for a more market-oriented exchange rate, interest rate liberalization, and opening the capital account. The change of leadership in China in the fall of 2012 also offered hope for economic rebalancing. In his opening speech to the 18th Party Congress in November 2012, Hu Jintao reiterated the need for interest rate, exchange rate, and capital account liberalization. Hu's speech reportedly was drafted by a group of high party officials led by his successor, Xi Jinping. Thus the speech almost certainly reflects the views of China's incoming top leadership. Moreover, one of Xi Jinping's first actions after taking office was to travel to the southern province of Guangdong, paying homage to Deng Xiaoping's famous Southern Tour, which reignited economic reform in the 1990s. Finally, Chinese leaders at all levels have identified income inequality as an important problem, and the NDRC is currently formulating a plan to address it.

Unlike reforms that rely on the cooperation of local governments or the many thousands of state-owned enterprises, the critical policy instruments needed to achieve economic rebalancing are centrally controlled. Rather than forcing changes that may be resisted by subordinate actors, most of these reforms simply require that the central government stop actively interfering with the market. The People's Bank of China, with approval from the State Council, can immediately move forward with liberalizing interest rates, the exchange rate, and the capital account. With respect to the interest rate, the dynamic of market competition would force all banks, even the large state-owned commercial banks, to begin offering competitive rates in order to hold on to deposits. This, in turn, is likely to put upward pressure on lending rates, which, in turn, will contribute to a reduction in the investment share of GDP. A more market-oriented renminbi simply requires the People's Bank of China to further reduce its intervention in the foreign exchange markets. More market-determined prices for energy simply require modifying NDRC's price-setting rules so that the changing market prices for oil and coal are fully reflected in prices paid by final users of refined petroleum products and electricity.

The policy changes needed to increase social transfers and income redistribution require cooperation from subordinate actors and thus are more difficult. However, these policy changes should still be achievable given their immense public popularity. Improving the social safety net requires cooperation by local governments, but it will be difficult for them to obstruct these popular programs. The rapid roll out of the rural medical and pension programs and the rates of participation rates suggest a strong base of support and the ability for the central and local government to work together on this issue. Chinese citizens frequently cite inequality as one of their highest concerns, and the NDRC has been working on a plan to address issue since 2004. The details of the plan that have emerged so far emphasize cracking down on monopoly sectors, increasing state-owned enterprise dividends, and providing more support for lower income groups. Public support for these proposals is likely to be strong, and vested interests will have a hard time resisting these policies if the central leadership vigorously and publicly promotes them.

The reforms needed for economic rebalancing are largely already government policy. Moreover, the central government can achieve many of these polices directly without interference by other actors. The ones that it cannot are extremely politically popular and should be difficult for any vested interest to resist. Therefore, there is no obvious reason why fundamental political reform has to precede economic reform. The slow pace of reform in the Hu Jintao–Wen Jiabao era stemmed from the top leadership's weak commitment to restructuring. The tremendous speed of economic growth over the past decade provided little incentive for policymakers to actually move forward with the difficult task of rebalancing. Rocking the boat is always difficult, especially when one's country is posting the highest GDP growth rates ever achieved by a large economy. It is only with the economic slowdown in 2012, which led to the lowest pace of expansion in a decade, that the rebalancing agenda took on greater urgency. As is the case with most political systems, difficult changes are made only when they are forced by necessity. The Communist Party continues to derive much of its legitimacy from the rising living standards made possible by sustained economic growth. As rebalancing increasingly becomes seen as a necessity to sustain economic growth, economic reforms will begin to be implemented with increased urgency. Political reform in China is certainly desirable and could be helpful in addressing a wide variety of social ills, but it is not a prerequisite to achieving a more balanced economy. Instead, a renewed commitment to economic reform by the top leadership, akin to the large reform push led by Zhu Rongji in the 1990s, is needed to break the policy deadlock and put the Chinese economy back on a more sustainable footing.

Implications for the United States and Policy Options

The ramifications of economic rebalancing in China for the United States come primarily through the reduction of China's external surpluses. When a country runs large and persistent external surpluses, it is siphoning away global demand from other countries. It is important to note that China's external surpluses have come down significantly over the past few years. These reductions, however, may be temporary because they were driven global economic weakness and unsustainably high levels of investment in China. The slow progress in increasing consumption as a share of GDP in China means that China will continue to add much more to global supply than global demand.

Economic rebalancing in China will increase consumption and add to global demand. This is likely to increase American exports and facilitate our own process of economic adjustment. A reduction in the American current account deficit will have positive benefits for economic growth and ameliorate some of the adverse effects of household and government fiscal consolidation. In some ways the economic challenges facing the two countries are mirror images. While China must take steps to increase consumption and reduce excess savings, the United States must decrease consumption and increase savings. Without economic rebalancing in China, the United States will face a worse external economic environment, making our fiscal situation more difficult to resolve.

While economic rebalancing in China would have benefits for the United States, it is not a cure-all for our current economic problems, nor should imbalances in China be used as a scapegoat for our massive buildup in public debt and the global financial crisis. Chinese economic rebalancing would be helpful, but domestic policy decisions will ultimately determine the fate of the United States economy.

This context is important to keep in mind while considering American policy towards China and specifically the role of congress. The United States has played a positive role in promoting economic reform in China in the past. From the time of Deng Xiaoping's initial reforms, through the accession to the World Trade Organization and more recently in the regular exchanges of the Strategic and Economic Dialogue, the United States has been a consistent voice for economic liberalization. American support, and sometimes criticism, has been mostly productive in terms of boosting the influence of reformers. Even during times of open disagreement, such as periodic barbs traded between the governments over the Chinese exchange rate, modest pressure by the US government is helpful in pushing Chinese policy in the right direction.

There are two important caveats to this rule. First, while American pressure can be helpful it is by no means decisive. Economic policy decisions in China will continue to be primarily based on domestic concerns. The same is true of the United States and any great power. We can help shape Chinese policy at the margin, but US negotiators should never forget that they are but one of many considerations that shape the ultimate decision. Policies that are viewed as threats to the core interests of economic and social stability or weakening state control in specified sensitive economic sectors will not be adopted, regardless of how much US negotiators press. The second caveat is that too much pressure from the United States can be counterproductive. Indeed, during the most heated periods of the exchange rate debate, some elements of Chinese public opinion began to view the issue through a nationalistic/anti-foreign prism. When policy debates take on this tone the domestic forces within China most opposed to reform gain influence.

The United States should continue to advocate for economic reform and when possible frame the debate in a positive way. A commitment by both countries to engage each other directly on new international economic agreements would be helpful in improving the tone of relations. Specifically, the rise in competing regional trade agreements in Asia should not prevent the US and China from engaging each other directly. A proactive policy by the United State combined with recognition of the limits of our influence is the best strategy for promoting economic rebalancing in China.