CENTRE FOR EUROPEAN REFORM
policy brief

Rebalancing the Chinese economy

By Simon Tilford

★ The scale and pace of economic development in China is without precedent, and has lifted hundreds of millions of people out of poverty in just one generation. But China's economy is not on a sustainable path economically or environmentally, and the country faces rising international tensions over its growth model.

★ The Chinese save too much and consume too little. The aim of economic growth is to boost living standards, and this requires China to consume more of what it produces. It is not in China's economic or political interests to run a huge trade surplus and invest that surplus in low-yielding assets in developed countries.

★ China needs to expand social security and healthcare insurance, liberalise financial services and allow the renminbi to strengthen. Better social provision would make the Chinese feel more secure and reduce the need to save. A stronger currency would facilitate the shift to a more domestically-driven, service-based economy by boosting disposable incomes and encouraging investment in the domestic economy.

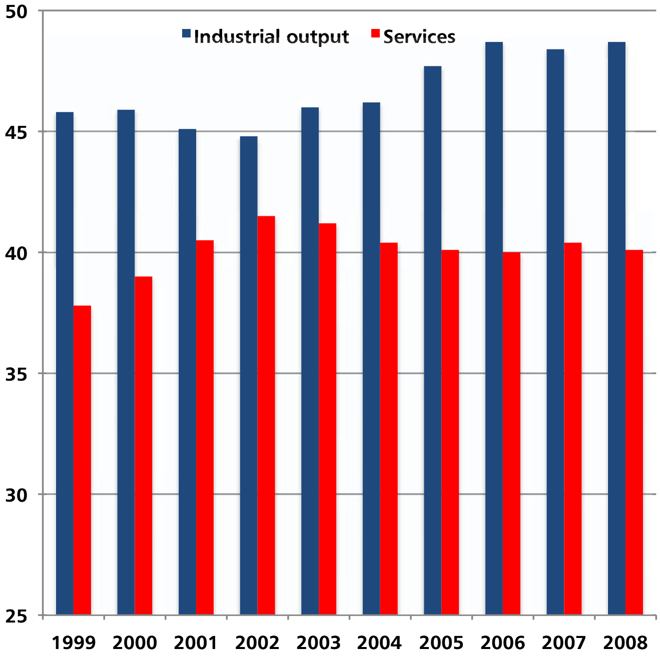
The transformation of the Chinese economy and society is astonishing. A country comprising almost a fifth of the world's population is shifting at lightning speed from an agrarian-based economy to an urban, industrial one. China has successfully lifted hundreds of millions of people out of poverty in just one generation. This is a phenomenal achievement; it took other countries much longer to do this. There was nothing inevitable about China's explosive economic development. Plenty of developing countries have failed to industrialise.

China's success reflects policies put in place by the Chinese authorities, in particular their decision to open up the economy to foreign investment, and their skilful management of the economy. But while acknowledging the success of China's development strategy, it is clear that China's economy is not on a sustainable growth path. The country needs to shift towards a more consumption-based, service-orientated economy. This policy brief argues that the transition will not be easy, but that it is necessary in order to put the Chinese economy on a sound footing economically, politically and environmentally.

The structure of the Chinese economy

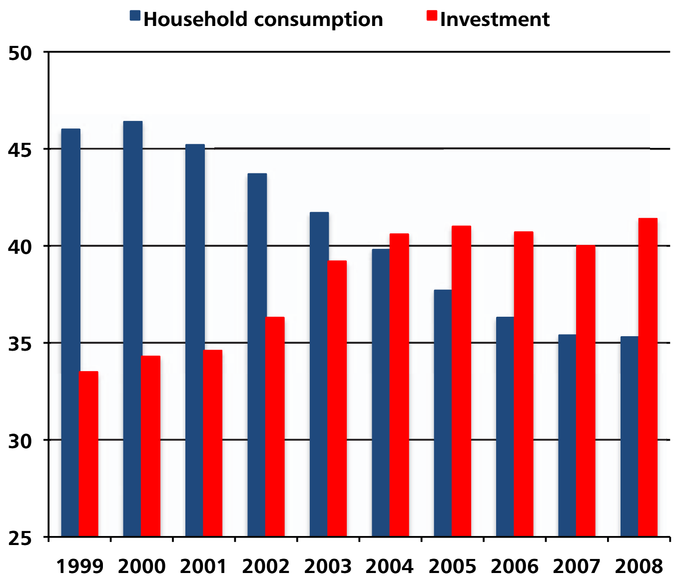
A few statistics quickly illustrate how skewed China's economic structure has become. Since 2004, China has devoted over 40 per cent of its GDP to investment. This is far higher even than in Japan, South Korea and Taiwan at the height of their investment-led economic development strategies. The reliance on investment in industry means that industrial output now accounts for almost half of Chinese GDP, and services for just 40 per cent. At least in terms of the relative importance of industry and services, China continues to look much more like a communist country than a capitalist one. Household consumption represented just 35 per cent of GDP in 2008, an exceptionally low share by any standards, while the household savings rate is running at over 20 per cent of income. (See charts one and two).

Chart 1: Industrial output and services (per cent of GDP)



Source: Economist Intelligence Unit

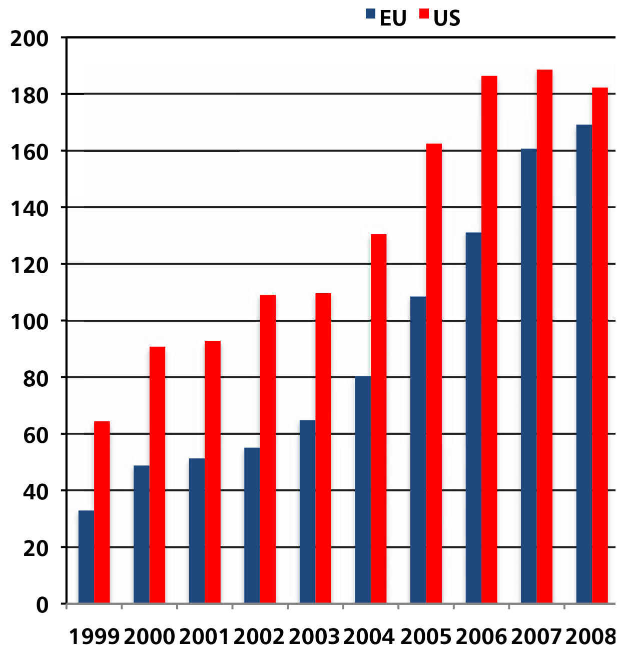
Chart 2: Household consumption and investment (per cent of GDP)



Source: Economist Intelligence Unit

There are no parallels for figures like these, either in other developing countries or during the industrialisation of the world's developed economies. China has been able to produce much more than it consumes by exporting the difference. This has led to some breathtaking trade imbalances. In 2008, China ran trade surpluses of close to €180 billion with the US and of €170 billion with the EU. China is now the EU's biggest supplier of imports, ahead even of the US. Ten years ago this would have seemed impossible. (See chart three). China's surpluses with Europe and the US are partially offset by deficits with Japan and other East-Asian economies, but China still ran an overall current account surplus of €300 billion in 2008 (equivalent to over 10 per cent of GDP). Although the surplus has fallen sharply in 2009, this was largely the result of the downturn in China's export markets, and not a change in the structure of the Chinese economy.

Chart 3: China's trade surpluses with the EU and US (€ billion)



Source: US Census Bureau; Eurostat

The surge of cheap Chinese products has benefited American and European consumers by boosting their disposable incomes. For their part, Americans have been able to live beyond their means because of the readiness of the Chinese authorities to purchase huge quantities of dollars, mostly in the form of US treasury bonds. This is an unprecedented reversal of the norm. Developing countries usually import capital because their domestic savings are inadequate to meet their high investment needs. For a developing country to be lending capital to the most important developed economy in order for it to buy the developing country's goods is not something that has happened before.

However, if something cannot go on forever, it will not. One country's surplus is another's deficit, and countries cannot run huge deficits indefinitely – not even the US. The global financial crisis has demonstrated this. The current-account deficits of the big consumer countries – the US being the most important – are narrowing. This trend will continue. US households, for example, are saving much more, and hence consuming less. Domestic consumption will continue to be the largest component of US GDP, but it is highly unlikely to be the largest contributor to GDP growth for several years to come. The US administration has made plain that the world can no longer rely on the US acting as the 'consumer of last resort'. For a long while, the US appeared to view its worsening net external asset position – the value of its overseas investments minus the value of foreigners' investments in the US – with equanimity. This is no longer the case.

After the current slump comes to an end, Chinese exports will never again play the same role in driving growth in the Chinese economy. Of course, world trade will recover. But consumption in developed economies will not provide anything like the kind of stimulus to the global economy that we have seen over the last 20 years, not least because of high levels of household indebtedness. Indeed, for the world economy to bounce back there will have to be lasting structural changes in both the surplus and the deficit countries.

Rebalancing the Chinese economy

China's leadership is aware that there needs to be a rebalancing of its economy if the country is to maintain its rapid pace of economic expansion. The Chinese prime minister, Wen Jiabao, recently said: "We should focus on restructuring the economy, and make greater effort to enhance the role of domestic demand, especially consumption, in spurring growth." The Chinese government knows that sustainable growth requires a very big shift from external to domestic demand, and from investment- and export-driven growth towards an economy in which consumption and services play a bigger part. But it is worth considering why this would be in China's interests. There are four principal reasons:

I. China is caught in a vicious circle.

China's current export-driven growth model requires a revival of world trade growth. But as already noted such a revival will not be possible without a degree of rebalancing in the economies with big current account surpluses, such as Germany, Japan and China. The Chinese and others will have to consume more of what they and others produce if global growth is to be put on a sustainable footing. China is simply too big to rely on an export-led strategy for growth. The rest of the world economy is not large enough to absorb China's surpluses ad infinitum. A growth strategy built around expanding to meet demand in foreign countries worked for Germany and Japan for a long time, but they will also have to rely more on domestic consumption for growth in the future.

II. Trade surpluses are as much a source of vulnerability as strength.

There is a tendency for countries running big trade surpluses to see themselves as stronger and more virile. But ultimately a country's economic power in the world rests on the size of its economy – not the size of its trade surplus. It is instructive that developed export-driven economies such as Germany and Japan were hit hard by the global slump. The fact that both these countries were running huge trade surpluses did not insulate them. This is unsurprising. These economies are hugely dependent on demand generated elsewhere, and this demand will recover only slowly. This may seem unfair. Why should 'prudent' economies where people save a lot and defer consumption suffer more than those where people save little and resort so readily to borrowing? The answer is that their prudent strategies – high savings rates and low consumption – were only possible because of the willingness and ability of others to save little and consume a lot, in the process running up unsustainable levels of indebtedness.

Over the medium to long term, this indebtedness tends to exert downward pressure on the value of the currencies of deficit countries. No country can expect to be able to run huge trade surpluses and be free from any exchange rate risk on the overseas investments made with those surpluses. For example, if China accumulates surpluses and translates these into foreign assets, the Chinese authorities have to expect that the value of these investments is likely to decline. This is obvious from the experience of Germany and Japan, which have run large current account surpluses for decades. Their net external asset positions are far less than the sum of their annual trade surpluses over the years (see chart 4). Inevitably, currency appreciation has reduced the value of Germany's and Japan's foreign holdings and increased the value of foreigners' investments in Germany and Japan. The experience of these two countries shows that running persistently large surpluses is not a good investment strategy.

Chart 4: Current account surpluses and foreign assets

	Germany	Japan
Combined current account surplus 1994-2008	€590bn	¥225trn
Rise in the surplus on the international investment position 1994-2008	€450bn	¥175trn

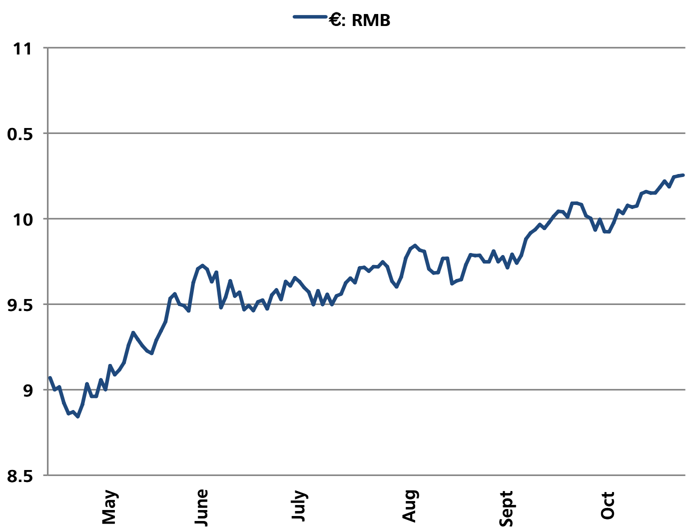
Source: Deutsche Bundesbank, Bank of Japan

III. China's current economic structure is a recipe for international tension.

The structure of the Chinese economy and the resulting trade surpluses will become a source of increasing political tension. At present, the US government is saying little about trade imbalances. The Chinese authorities are major investors in US treasuries, and the US needs to reassure investors that it can borrow the sums needed to finance its budget deficit. However, US acquiescence this will not persist indefinitely. The US fiscal deficit will fall as the US economy recovers. At the same time, protectionist sentiment in the US is unlikely to go away, especially if the world's big surplus countries – China, Germany and Japan – resist pressure to rebalance their economies. The US administration's decision in September 2009 to impose heavy duties on imports of Chinese tyres is a foretaste of the tensions to come.

Similarly, China's trade surplus with Europe will become an increasing source of friction. Unlike the Americans, the Europeans are not dependent on Chinese capital to help fund their fiscal deficits. As a result, they can afford to allow relations with China to deteriorate. So far, they have been very cautious about criticising China for fear of damaging their business interests in the country. But against a backdrop of very weak economic growth in Europe, high unemployment and a widespread perception that European firms are not being treated fairly in China, trade relations with Europe could easily worsen. The steep rise in the value of the euro against the Chinese currency is a source of mounting anger in Europe, reflecting as it does China's refusal to allow a meaningful appreciation of the RMB against the weakening dollar to which the Chinese currency is effectively tied.

Chart 5: Exchange rate between the euro and the RMB (2009)



Source: European Central Bank

IV. China's current growth structure imposes huge environmental costs on the country.

Massive investment in energy-intensive industry has contributed to a dramatic rise in China's emissions of greenhouse gases and put the country under immense environmental strain. The impact of China's industrial structure on its increasingly scarce water supplies is also a cause for real concern. On current trends, China could soon experience widespread water shortages.

China is doing much more than it is given credit for to curb the rise in its emissions of greenhouse gases. For example, it has introduced energy efficiency standards and set targets for the proportion of energy to be generated from renewable sources. But its efforts are being overwhelmed by its industrial structure. Per capita emissions will continue to rise rapidly. A significant proportion of the rise in China's energy consumption – and hence emissions of greenhouse gases – reflects production for export. Much of the world's energy-intensive industry has shifted to China, and this shift has allowed other countries to reduce their emissions while still consuming the same goods. However, China can expect little understanding of this predicament from other countries when it comes to international negotiations over how to curb global emissions of greenhouse gases.

Services are not a lower form of activity

Services are often seen as a softer form of economic activity than industry. Even in developed economies, the shift to a greater focus on services is sometimes seen as a sign of failure, and of 'de-industrialisation' that should be resisted. For example, politicians in Germany and Japan are often dismissive of economies such as the US and Britain because of their big service sectors.

All major economies need to retain manufacturing industry. But there is no need to fetishise manufacturing and exports. After all, the point of exporting is to earn the money needed to buy imports. There is little point to economic growth if it does not feed through into rising domestic consumption. The resistance to a shift towards a more service-based economy is one reason why German and Japanese economic growth has been so slow over the last 20 years. As countries get wealthier, the shift to services is inevitable and welcome. Wealthier people spend a growing proportion of their incomes on services and a smaller proportion on goods. Few households with fridges or washing machines go out to buy additional ones.

Services are not a lower form of activity; they are central to any successful market economy. For example, growth in services such as law, accountancy and consulting is needed to support wider economic development, and to ensure that the rule of law prevails in commercial matters. The spread of modern supermarkets and hypermarkets requires modern logistics and distribution networks. First-rate education and healthcare are crucial if an economy is to be successful in knowledge-based industries. Tourism, both domestic and international, as well as the creative industries, ranging from entertainment to fashion, are not second order activities, but drivers of growth too.

So a more service-based economy would not be a softer, less advanced economy. China would miss an opportunity if it made the same mistake as other export-orientated economies and resisted a shift away from excessive dependence on industry. A shift to a more service-based Chinese economy is possible and should be welcomed.

The challenges ahead

The rebalancing towards a more consumption-driven economy where services play a bigger role is necessary. But it would be foolish to argue that it will be easy, not least because there are powerful groups in China that benefit from the current bias towards heavy industry and exports. These vested interests will fight economic restructuring which reduces their preferential access to capital and the implicit export subsidy provided by an artificially low exchange rate. Assuming opposition can be overcome, the task facing the Chinese government will remain a considerable one. Changing China's underlying growth dynamic will be difficult – and harder than addressing the excessive consumption bias of the US economy, for example. How can the necessary change towards a domestically-orientated, service-based economy be brought about?

No-one could accuse the Chinese authorities of being slow to react to the financial crisis and the resulting decline in demand for China's exports. The Chinese fiscal programme in response to the crisis has been huge – probably around 15 per cent of GDP in 2009 if government-backed lending is factored-in. This is far bigger than the stimulus packages in other big surplus economies. Despite the global slump, China's rate of GDP growth was over 7 per cent in the first half of 2009, confounding the fears of some economists that China would suffer a more dramatic slowdown. Consumption has proven resilient, with car sales in particular booming as a result of sales incentives introduced by the government. But much of the stimulus has taken the form of increased lending by the banks to state-owned enterprises, rather than measures to bolster consumption, with the result that the proportion of GDP accounted for by investment spending has increased further. Investment's share of GDP jumped to 45 per cent of GDP by the middle of 2009. The stronger the underlying bias in the Chinese economy towards industry becomes, the bigger the ultimate problems of overcapacity and bad bank debts will be.

Economic growth driven by cheap domestic credit to industrial enterprises will not prove any more sustainable than growth driven by excessive dependence on exports. China might succeed in becoming less reliant on foreign demand, but at the expense of an investment bubble, lots of excess capacity and then, potentially, deflation. Much more will have to be done to increase private consumption's share of GDP. There are obviously no easy solutions, or the Chinese government would already have adopted them. But a number of steps would help facilitate the necessary adjustment.

I. Increase spending on social security and health

The Chinese save too much. From the perspective of the individual household, saving a huge proportion of its income may be the rational thing to do. But it is damaging from the perspective of the Chinese economy as a whole. Excessive saving can be just as destabilising as excessive consumption, because it leads to chronically weak domestic demand and excessive dependence on exports. Much as US households need to save more and spend less, Chinese ones need to save less and spend more.

Much has been made of the allegedly strong cultural disposition to save on the part of the Chinese. The Chinese may well be more cautious than the famously optimistic Americans. But the principal reason for China's high savings rates has little to do with culture and a lot to do with public policy. The absence of any meaningful social security system and the high cost of healthcare and other essential services relative to average incomes ensure that the Chinese have no option but to save a very high proportion of their incomes.

The Chinese government has been trying to address this. State spending on education, health, social security and unemployment benefits almost doubled between 2004 and 2008. But China's social safety net remains very patchy – and as a result, the Chinese people understandably remain very risk-averse. The authorities need to move quickly to ensure universal health and social security insurance.

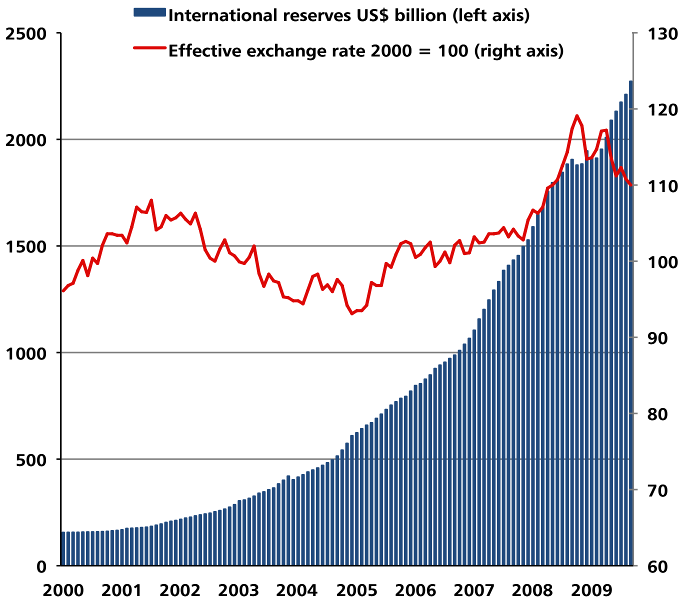
II. Cut income taxes

The Chinese authorities should shift the burden of taxation away from consumption and onto investment. Many Chinese companies – especially state-owned industrial ones – pay little tax on their profits, which encourages them to invest too much in new capacity. Cuts in personal taxes would boost disposable income. Higher incomes would mean that China was able to consume more of what it produces – in the process reducing its dependence on exports and the vulnerabilities that accompany this dependence. Even if a shift in the burden of taxation from the consumer to the industrial sector were to reduce revenues from income and consumption taxes in the short-term, stronger consumption would boost revenues in the medium-term.

III. Liberalise financial services.

Real interest rates on loans to state-owned enterprises are very low, encouraging excessive investment in capital-intensive industry. But the availability of consumer credit is still poor because the consumer credit and mortgage markets are underdeveloped. Chinese households need to be able to buy cars on credit rather than having to save for them. Reform of the financial system to encourage relatively more consumer borrowing and less lending to state-owned industrial enterprises would promote the structural rebalancing of the economy that is needed.

Chart 6: The RMB's effective exchange rate and China's foreign currency reserves



Source: Economist Intelligence Unit (JP Morgan, People's Bank of China)

IV. Allow the renminbi (RMB) to strengthen.

There is no doubt that the Chinese currency is strongly undervalued, although estimates of the extent of the underpricing of the currency vary hugely. What is not in doubt is that the RMB is becoming steadily more undervalued, as the value of the dollar (to which its value is tied) has fallen. Despite huge current account surpluses, the real effective value of the RMB (that is, adjusted for differences in inflation rates between China and its trade partners) has fallen steadily in recent years (see chart six.) China has prevented the RMB from appreciating against the dollar by intervening in the foreign exchange market to purchase vast quantities of dollars. Between the beginning of 2000 and September 2009 China's holdings of foreign currency (predominately in the form of dollars) increased almost 15-fold to $2.3 trillion, which is equivalent to over 40 per cent of Chinese GDP. Over the first nine months of 2009 alone, China's reserves rose by $325 billion.

The undervaluation of the currency is effectively a massive export subsidy. A stronger currency would facilitate the shift to a more domestically-driven, service-based economy by boosting disposable incomes and encouraging investment in domestically orientated sectors rather than export-orientated manufacturing. The timing of the necessary revaluation will obviously be tricky. Excessive appreciation right now could further depress exports. Nevertheless, there is no doubt that a stronger RMB is in China's long-term interest. The longer the Chinese authorise delay the inevitable revaluation, the more imbalanced China's economy will become and the greater the exchange rate risk they will be exposed to on their holdings of foreign assets.

Conclusion

China's economy and society are undergoing an extraordinary transformation, with hundreds of millions of people being lifted out of poverty in record time. But a big shift from external to domestic demand, and from investment- and export-driven growth towards an economy in which consumption and services play a bigger part, is needed.

Exports will never again play the same role in driving growth in the Chinese economy as they have over the past 20 years. The country needs to consume more of the fruits of its own labour. Average living standards in China are still very low and it makes little sense for China to be exporting so much of what it produces and then investing the surplus in assets which will lose value following the inevitable revaluation of China's currency.

Rebalancing the economy will not be easy. The Chinese will have to work hard to address the reasons for the excessive rates of savings, for example by aggressively expanding social security and healthcare insurance and liberalising the financial services. Crucially, they need to allow the RMB to strengthen, which would encourage consumption and the growth of the service sector. But if China fails to bring off this shift, it will struggle to put its economy on a sustainable economic and environmental course, or avoid international political tensions.

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