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China: shifting to a new growth model

- Despite the unprecedented pace of economic expansion, China's growth model has developed two significant imbalances, namely high investment and low consumption and a huge surplus in the current account balance.
- The global crisis has revealed significant weaknesses in China's growth model, raising questions about the sustainability of China's high economic growth rates.
- China urgently needs to rebalance its economy, in an orderly way, away from excessive reliance on investment and exports towards higher domestic consumption.
- Such a transformation should make the country less susceptible to global trends and substantially boost living standards. It would also hold out the prospect for a more balanced and sustainable growth than the present model.

Over the past two decades China's economy has grown on average by about 10% per annum, reflecting productivity gains, cheap costs for energy, utility, land, capital and other resources and rapid exports expansion. Despite the unprecedented pace of economic expansion, this growth model has developed two significant imbalances. The one is linked to high investment and low consumption that gave rise to rapid capital accumulation. The other imbalance is related to the huge surplus in the current account balance. In the meantime, the global crisis has revealed significant weaknesses in China's growth model and the aforementioned conditions are now coming to an end. Labor shortages in key industries are a nation-wide phenomenon. The cost of resources is rising and net exports have now negative contribution to growth (Figure 1). In addition, maintaining high rates of investment adds to overcapacity putting pressure on profits and, in turn, leading to company closures. What's more, excessive reliance on exports exposes the economy to the fluctuations of the global economy. Therefore, increasing questions have been raised about the sustainability of China's high growth rates. Relatedly, the issue of how the imbalances of the economy should be addressed in order to make growth sustainable in the long run has come to the fore. Boosting consumption appears to be an important way of reducing China's imbalances. Should China fail to address the structural problems of its economy, then the risk of a deeper slowdown over the medium-term could increase considerably.

Patterns in China's domestic and external demand: producing too much but consuming too little

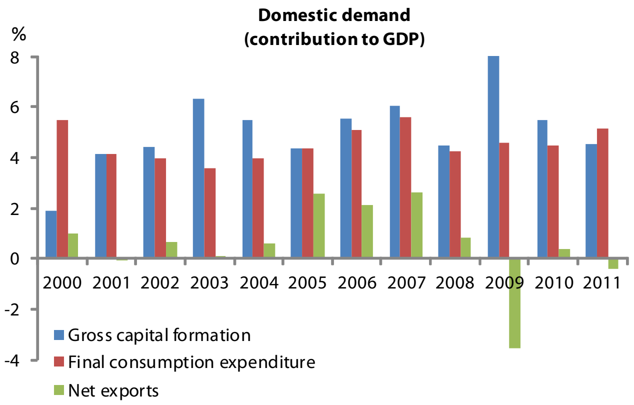
Investment

Over the past years, various incentives from the Chinese government, namely tax breaks, low energy, utility and land prices, in combination with the low cost of capital, helped to keep input costs low. Consequently, profits of Chinese companies have risen sharply, making return on investment very attractive. In addition, the 2008-2009 stimulus package, along with the government's emphasis on social housing gave further boost to investment. As a result, investment's share in GDP rose from 34% in 2000 to a record high of 46% in 2011 (Figure 2).

External demand

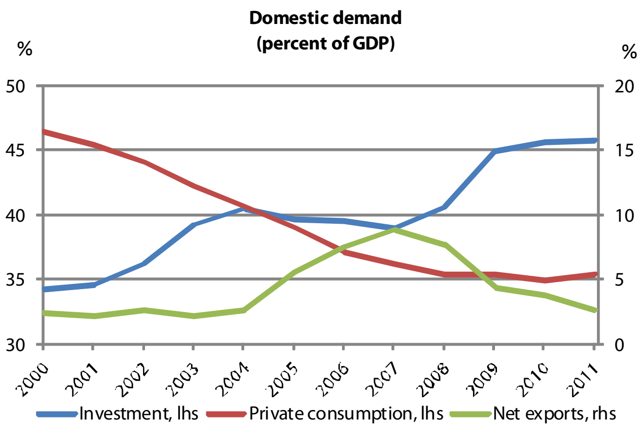
Meanwhile, China's current account balance has increased rapidly since the beginning of the past decade, from around 1% of GDP to 10% in 2007. The rapid widening of the trade balance accounted for most of the increase (Figure 3). Net exports rose sharply from almost 3% of GDP in 2004 to a peak of 8.8% of GDP in 2007. This widening of the trade balance surplus reflected the overinvestment in manufacturing, the excess capacity in various industries and the high competitiveness of exports attributed mainly to high productivity growth. The widening of the trade surplus was driven also by import substitution, particularly in the steel and heavy machinery sectors.

Figure 1



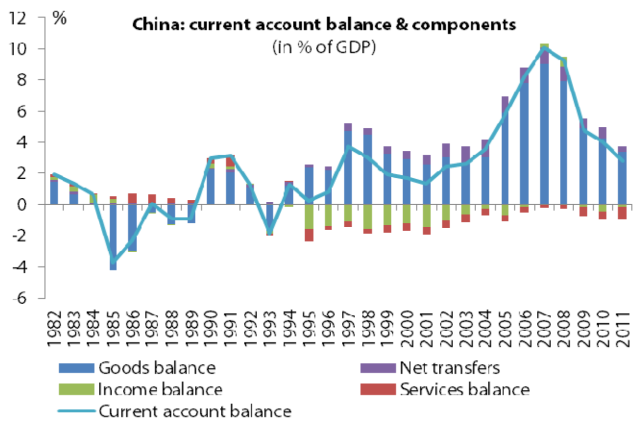
Source: Ecowin

Figure 2



Source: Ecowin

Figure 3

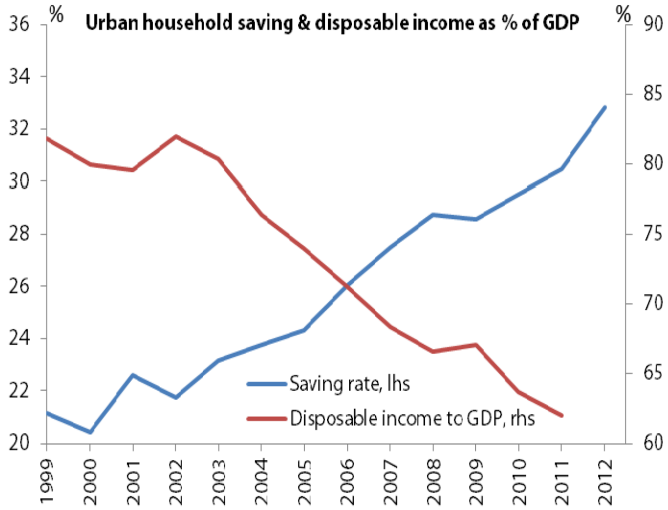


Source: Ecowin

Saving rate

Reflecting the increasing ratios of both investment and current account surplus, the domestic saving rate (savings of households, companies and government) has been rising even faster, climbing to over 50% of GDP starting in 2006. The bulk of high savings has come mainly from the corporate sector. During the high profit period Chinese firms used to save and reinvest their gains, instead of distributing them to their shareholders. Indeed, domestic enterprises have managed to increase their market share both in the domestic market and abroad. In particular, Chinese companies have surpassed foreign-invested enterprises as the leading source of export growth. Regarding households, the urban savings rate has increased from 21% in 2000 to 33% in 2012 (Figure 4) (urban households account for about two-thirds of national income). This increase reflects a greater incentive for households to save for house purchase, healthcare, education and retirement, against a background of reduced public provision of key social services.

Figure 4



Note: Saving rate of urban households = 1 - (urban per capita household consumption/urban per capita disposable income)

Source: Ecowin

Consumption

The high precautionary savings of Chinese consumers, in turn, has led to a significant fall in domestic consumption's share to GDP, which did not keep up with the overcapacity created by rapid investment. Total consumption spending fell from 62% of GDP in 2000 to 49% in 2011, with the household consumption rate falling by 10 percentage points in 2000-2011 to 35%, among the lowest shares in the world. A significant proportion of the decline is attributable to a falling share of national income going to households, including wages, investment income and government transfers. The urban disposable income-to-GDP ratio fell from 80% in 2000 to 60% in 2011 (see Figure 3). It should be noted, however, that the low consumption-to-GDP ratio is not the result of slow consumption growth per se. In fact, consumption by Chinese households has grown at an average real rate of 8% since the early 1990s. Indeed, a decline in consumption relative to GDP was to be expected, as the structure of the economy favored high investment and export growth over domestic consumption growth.

International comparison of the components of GDP

Data illustrated in Table 1 suggest that China is an outlier in the composition of its expenditure compare to other important advanced and emerging economies. While in the other countries consumption comprises an average of much more than 65% of GDP over the period 2000-2010, in China the corresponding share is about 50%. Additionally, investment accounts for less than one third of GDP in the other countries. By contrast, in China the investment ratio is about 40% of GDP and exceeds by far the investment ratio of industrialized countries.

Growth has been slowing over the past two years, mainly due to the global slowdown

In the meantime, the global financial crisis and the ongoing euro area crisis have weighed on China's growth prospects, creating heightened worries about the extent to which China will slow down, given its growing global economic weight. Indeed, China's economy eased significantly during 2012, strongly affected by the lagged effects of earlier monetary tightening, the slowdown in demand from its major export partners, particularly US and Europe which account for about 40% of China's total exports, and supply-side bottlenecks. Real GDP growth eased to an average of 7.7% y-o-y in the first three quarters of 2012, down from 9.3% y-o-y in 2011.

Meanwhile, dampening external demand and the large 2008-2009 stimulus package that skyrocketed investment growth, led domestic demand and, consequently, imports to grow even faster than exports. Besides, export growth decelerated significantly, as China's competitive position started to lose steam due to rising wages, labor shortages in key industries and a stronger exchange rate (Figure 5). Eventually, the current account surplus fell considerably from a peak of 10.1% of GDP in 2007 to 2.5% in 2012. However, it seems that this decline is mainly the result of the global economic slowdown, as there is little evidence so far of a clear shift towards consumption, a lower domestic saving rate or a slowdown in investment growth. China's economy remains to a large degree internally imbalanced. Consumption's falling share of GDP has only stalled since 2008, but there is not a significant pick up so far. Also, investment as a share of GDP ended up even higher during the global crisis. It rose by close to 7 percentage points between 2007 and 2010. As a result, despite the temporary reduction of the external surplus, the latter could be expected to rise again as the world economy rebounds gradually.

A structural shift of the economy is needed in order to ensure the transformation of economic development patterns

China's large external footprint means that it will be increasingly influenced by global economic and financial conditions. Moreover, the persistence of overcapacity created by high rates of investment could lead to price declines, bankruptcies and non-performing loans. It could also raise exports, boosting again China's current account surplus. This could trigger retaliatory trade action that may be more harmful to all parties, including China. Consequently, China urgently needs to rebalance, in an orderly way, its economy away from excessive reliance on investment and exports towards more domestic consumption. Such a transformation should make the country less susceptible to global trends and substantially boost living standards. It would also hold out the prospect for more balanced and sustainable

Table 1

The components of GDP in selected economies, average 2000-2010, % of GDP

	Total consumption	Household consumption	Investment	Net exports	Domestic Saving*
China	53.5	39.2	39.8	4.5	46.5
Brazil	81.1	61.0	17.1	1.1	18.9
India	71.2	59.8	28.5	-2.7	28.8
Korea	68.4	54.4	29.0	2.2	31.6
Russia	67.1	49.4	19.4	11.6	32.9
Germany	76.9	57.9	18.4	4.6	23.1
Japan	76.3	57.9	22.5	1.2	23.7
UK	85.7	64.7	16.6	-2.6	14.3
US	86.1	70.2	18.2	-4.5	13.9

** Sum of households, companies and government savings as % of GDP*

Source: World Bank, World Development Indicators growth than the present model.

The question now is whether China has finally begun the long-waited rebalancing process. Internal rebalancing hinges on increasing household real disposable income, reducing national saving and limiting the incentives to overinvest. Moreover, there should be measures to reduce net exports and shift the domestic framework in favor of non-tradables. As we have already mentioned, little improvement has been achieved so far in this area. The Chinese government clearly recognizes risks associated with the persistence of imbalances. Thus, in the Chinese 12th five year plan (FYP) announced in March 2011 the government has initiated various measures that aim at transforming the growth model through rebalancing the economy. Specifically, key goals in the plan are promoting domestic consumption, the improvement of Chinese citizens' living standards through higher household income, a better social security system, energy conservation and environmental protection. Another important feature of the new FYP is the concept of "inclusive growth", which means reducing wealth disparity by ensuring the benefits of economic growth are spread to a greater proportion of Chinese citizens.

Key mechanisms for rebalancing

Raising the cost of capital

So far Chinese banks provided cheap financing by tolerating a large level of non-performing loans. Artificially low interest rates is one of the policies that supported low household consumption so far, as they reduced household income by trimming the return on household savings. If the government hikes the cost of capital, this will reduce the incentive to invest in economically dubious projects and would nudge China away from investment-led growth. However, increasing the cost of capital will be costly particularly for the local governments which are highly leveraged. On the other hand, it is far from clear that an increase in interest rates will boost consumption as it could lead to further increases in the savings rates of private households.

Financial sector reform, specifically interest rate and exchange rate liberalization

A more competitive financial market should provide greater access to credit for private firms, hence reducing their incentives to hold large savings and encourage them to redistribute more profits as dividends.

The authorities have already made an important step towards interest rate liberalization in China. In June, the central bank of China raised the ceiling on the deposit rate and lowered the floor of the lending rate. In other words commercial banks are able to raise the deposit rate offered by 10% and lower the lending rate by 20%. Commercial banks now have increasing flexibility to set their own lending rates. The implication is that the pricing of capital would be more market-based and benchmark interest rates would be less important. This should allow the interbank interest rate to become more stable. Also, it should help reduce financial risks and economic imbalances.

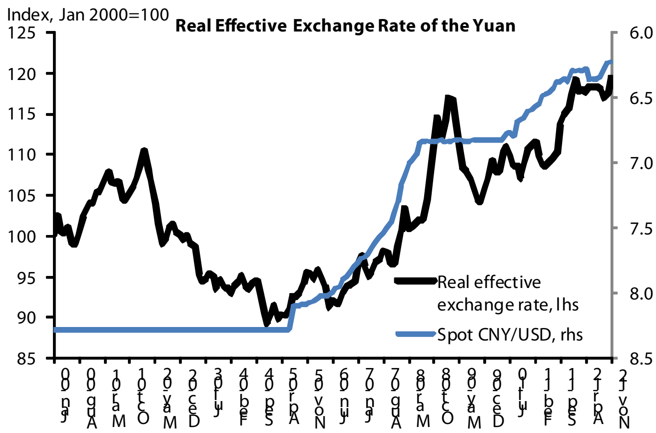
At the same time, April's decision to widen the yuan's trading band against the dollar for the first time since 2007 is an important step toward a convertible currency that allow the market to play a stronger role in determining the level of the exchange rate.

Yuan appreciation

International political pressure for China's currency appreciation has intensified over the past few years, as Chinese exports growth continues to outpace most major economies and China's current account surplus implies an export deficit for its trading partners. For example, the U.S. goods trade deficit with China accounted for 41% of the overall U.S. goods trade deficit in 2011.

Letting the renminbi to appreciate further will help narrow the trade surplus without destroying domestic demand. The RMB has appreciated over 30% against the US dollar since 2005, which has contributed to the appreciation of the real exchange rate (Figure 5). An appreciating domestic currency will help Chinese consumers, as their imports costs will decrease.

Figure 5



Source: Bloomberg, Ecowin

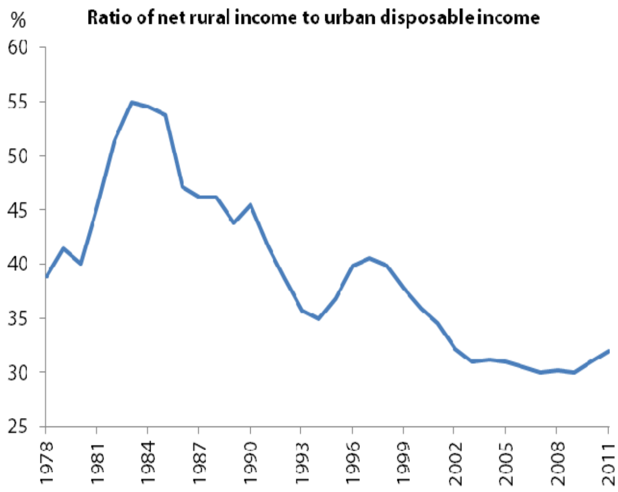
Raising Chinese wages

Rapid wage increases will be costly to labor-intensive manufacturers, affecting their competitiveness. Also they will encourage high inflation. But in general, such a move should be a very positive step towards rebalancing of the Chinese economy, given that rapid wage increases would increase household income and, thus, promote consumption. The increase of consumption would reduce the economy's reliance on exports and investment. Wage increase would help particularly low-paid workers, contributing to a more equal income distribution.

Increasing and improving public provision

The high saving rate of Chinese households has been partly attributed to their lack of key social services. Hence, strengthening the education services and the social safety net and, particularly, the pension and healthcare insurance system, would reduce the propensity of Chinese households to save for precautionary reasons, improve labor productivity and, thus, help boost consumption. According to the latest data from the World Health Organization, China has already made some progress in the healthcare provision, but still remains in a worse position than the global average. The general government expenditure on health as percent of total health expenditure in China increased from 38.3% in 2000 to 52.5% in 2009 (global averages: 56.3 in 2000 and 59.1 in 2009). Similarly, the private share of total expenditure on health decreased from 61.7% in 2000 to 47.5% in 2009 (global averages: 43.7 in 2000 and 40.8 in 2009). Given that healthcare provisions are key initiatives in the 12th five year plan, we expect further improvements in this area. Reforms in the healthcare system will eliminate social inequality, which has been getting worse since the early '80s. A minor improvement has been witnessed only recently, reflecting the government's efforts to provide basic education and healthcare to rural households. The rural/urban income gap has started to improve slightly since 2009 (Figure 6).

Figure 6



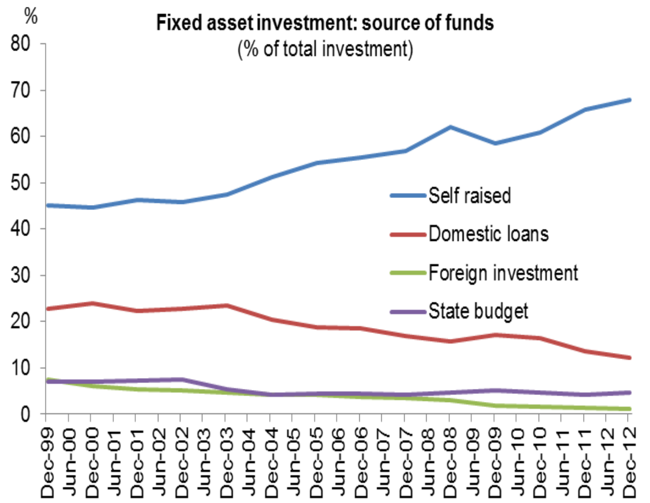
Source: Ecowin

Implications for the world economy

The rebalancing of the Chinese economy will likely have several implications for the global economy, given its growing contribution to global output. China has contributed about 20% to global growth over the past decade. Given the sluggish growth in advanced economies, this rate is expected to surpass 30% over the coming years. Moreover, China's trade flows rose from less than 4% of the world total in 2000, to more than 10% in 2011, and is the second largest trading nation after the US. The transition to the new growth model may weigh on global growth via reduced investment that would lower Chinese demand for raw materials and capital goods. China is a key player in global commodity markets. Consequently, slowing growth in China will hurt commodity producers, such as Australia, Brazil, or South Africa, as well as capital goods manufacturing economies with sizeable exports to China, such as Germany and Japan. According to IMF[1], the impact of a percentage point slowdown in Chinese investment would be a reduction of global growth of 0.1%. The impact is about five times larger than in 2002. It's worth noting, though, that since China's investment has been financed predominantly by self-raised funds, namely own savings and corporate profits, and not from foreign savings, we believe that China will manage a smooth rebalance (Figure 7).

Meanwhile, the transition to a consumption-led growth does not indicate a significant positive impact on consumer goods exporters. China's share in global consumer imports has increased at a slower pace over the past fifteen years than its share in global consumption[2]. Currently, China's imports of goods as a share of global consumer goods imports stands only at 2%.

Figure 7



Source: Ecowin

All in all, China's economy has entered a period of subdued growth, with weak exports, credit and property prices. The three decades of double digit growth is over and China's potential GDP growth is gradually slowing below 8.0%. The government is simply accepting that trend growth has slowed. Indeed, in March, China's Prime Minister lowered the annual growth target for the first time in eight years from 8.0% to 7.5%. A successful

[1] *IMF Working Paper, Investment-Led Growth in China: Global Spillovers, November 2011*
[2] *IMF Asia and Pacific Regional Economic Outlook, April 2012*

implementation of the rebalancing reforms should lead to a more sustainable growth model.

Many continue to worry about the risk of a hard landing, namely an even sharper and sustained deceleration in GDP growth. However, this is not our base case. Policymakers are more determined to take measures to support growth and ensure social stability. Generally, the probability of a hard landing has diminished significantly, largely because, if needed, China has considerable room to ease monetary and fiscal policy to support growth in the worst case scenario. Unlike advanced economies, China has comfortable leeway to cut interest rates as they are still at a relatively high level (for example the RRR for large banks stands at 20%). Moreover, China's fiscal situation is relatively healthy. The budget for 2012 calls for the fiscal deficit to rise to 1.5% of GDP this year from 1.1% of GDP in 2011, which is still a low level. Overall government debt remains at comfortable levels, despite the increase in local government borrowing. National government debt (including local governments' debt) is about 45% of GDP, well below that of advanced economies, enhancing the government's capability to respond to a marked slowdown in growth. In addition, in a worst case scenario, some of the tightening measures targeting the calming down of the property market could be withdrawn. The problem is that both monetary and fiscal easing entails some drawbacks for the Chinese economy at this stage. Specifically, monetary easing will underpin a rebound in the property market, something that will not be greeted as good news by the government, given its commitment to contain house prices. Meanwhile, fiscal easing will have to rely mainly on investment and, particularly, infrastructure investment in order to have a significant impact on the economy. Apparently, this is not desirable at the moment, given China's attempt to rebalance the economy away from investment and towards consumption. That said, we believe that policymakers will be very cautious from now on in implementing their policies and any stimulus will likely be moderate and targeted. We project growth to moderate to 7.7% in 2012 and 7.9% in 2013 from 9.3% in 2011.

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