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CHINA'S LONG MARCH TOWARD ECONOMIC REBALANCING

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KEY POINTS

- China's role in the global imbalance is closely linked to its domestic imbalance.
- Chinese policy makers have long been aware of the dual imbalance and the imperative to shift to economic growth driven by domestic consumption.
- They have taken limited steps in changing the development model, but political obstacles have slowed the pace of reform.
- The new leadership seems serious about deepening economic reform despite political resistance, but without political reform, the prospect of success remains dim.

INTRODUCTION

After more than three decades of sustained economic growth, China has become the second-largest economy in the world. Chinese policies and behaviour have come to shape the global economy in profound ways and what China does, or does not do, at home and abroad often has broad implications for the rest of the world. This policy brief examines China's external and internal economic imbalance and analyzes the political obstacles hindering its economic rebalancing.

CHINA'S DUAL ECONOMIC IMBALANCE

In the years leading up to the global financial crisis (GFC) of 2007-2008, many commentators noted China's large current account surplus, which reached 10 percent of its GDP in 2007, and its insatiable accumulation of foreign reserves, which amounted to US$1.5 trillion in the same year. Although the GFC did not actually result from a disorderly unwinding of the current

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AUTHOR'S NOTE

This policy brief draws on research conducted by the author for "The Limits of the Exchange Rate Weapon in Addressing China's Role in Global Imbalance" in *The Great Wall of Money: Politics and Power in China's International Monetary Relations*, edited by Eric Helleiner and Jonathan Kirshner, Ithaca, NY: Cornell University Press, forthcoming 2014.

account imbalances, critics continued to stress China's role therein, blaming China for the "saving glut" that encouraged excessive and substandard lending in the United States (see, for example, Bernanke 2005, 2007; Bergsten 2008). The root of this problem, according to many policy pundits, was China's manipulation of the value of its currency, the renminbi (RMB). By implication, liberalizing the exchange rate regime would reduce China's current account surplus to a normal level and help rebalance the global economy (see, for example, Cline 2012).

In the years since the GFC, this narrative has continued to dominate the public discourse about China and the global imbalance; however, as specialists have come to recognize, this narrative is seriously flawed. First of all, it exaggerates China's role in the global imbalance. Chinese trade has a heavy component of processing trade, which makes it the final assembler of inputs from neighbouring economies. According to a recent study, in 2008 East Asian economies supplied 77 percent of China's processing imports and absorbed only 29 percent of its processing exports (Xing 2012). What may seem to be China's contribution to the global imbalance has in fact been the collective contribution of East Asian economies. In 2008, for example, the United States had a deficit of US$285 billion with China, of which 60 percent was due to processing trade (ibid.).

Second, the focus on China's exchange rate policy is misplaced. Since 2005, the Chinese government has allowed the RMB to appreciate by about 25 percent in nominal terms or 30 percent in real terms against the US dollar, but such significant appreciation of the Chinese currency has not produced a significant effect. From 2005 to 2008, China's current account surplus continued to grow. From 2007 to 2011, the ratio of China's current account surplus to its GDP dropped from 10.1 percent to 1.9 percent, but this was mainly due to China's post-GFC stimulus plan and the economic recession in Europe and the United States. The IMF has predicted that, after the economic downturn, China's current account surplus will rise again — to 4.3 percent of its GDP by 2017 (IMF 2012b). With regard to the bilateral trade balance with the United States, China's surplus already rebounded in 2010 and 2011 to above its 2007 level, despite the appreciation of the RMB.[1]

While many politicians still cling to the conventional narrative about China's external imbalance and the exchange rate regime, a new perspective has gained ground among economists and China scholars. This perspective views China's external imbalance as an integral part of the country's development model in recent years. Since the early 2000s, the Chinese economy has been characterized by rapidly rising shares of national savings and declining shares of household consumption.[2] According to the World Bank, from 2000 to 2006, China's gross domestic savings increased from 37.5 percent of GDP to over 50 percent. In the same period, household consumption dropped from 47 percent of the GDP to 35 percent.[3] With such low domestic consumption, Chinese economic growth has relied heavily on investment and exports. Simply liberalizing the exchange rate regime will not solve the dual imbalance between exports and imports, and between investment and consumption. Broader measures to increase domestic consumption are required.[4] The influence of this perspective has been growing. In the last few years, the IMF has shifted its attention away from the exchange rates. In the 2012 and 2013 Article IV consultation, the IMF argued that the Chinese currency was moderately undervalued, in contrast to its assessment of "substantial undervaluation" in 2011. And in both years' reports, the IMF mission urged China to increase domestic household consumption (IMF 2012a, 2013).

Interestingly, while the dual-imbalance perspective has only recently become widely accepted among Western specialists, the Chinese government began to take note of it much earlier. As early as the late 1990s, the Asian financial crisis alerted Chinese leaders to the uncertainty of the international market. They began to emphasize the need to expand domestic demand (*kuo da nei xu*). The emphasis then was on increasing domestic investment, including developing the western regions of the country. When former President Hu Jintao and former Premier Wen Jiabao took over the leadership in 2003, they turned their attention to improving people's standard of living. Since the GFC, the Chinese government has intensified its rhetoric about "changing the development model" and expanding domestic consumption (Qi 2009; Yu 2010).

SMALL STEPS TOWARD REBALANCING

Soon after they came into office, Hu and Wen called for raising the share of household income in the country's GDP. In 2004, the government began to draft a plan for income distribution reform aimed at helping low-income groups. In 2006, the government eliminated

1 See www.census.gov/foreign-trade/balance/c5700.html#2007.

2 In absolute terms, household consumption in China has risen steadily. In fact, it has risen at a faster rate than most other countries in the world.

3 See http://data.worldbank.org/indicator/NE.CON.PETC.ZS?page=2.

4 Beijing-based economist Michael Pettis has been an early and vocal proponent of this view (see, for example, Pettis 2013a). Many of his articles from the last few years can be found on his blog at http://blog.mpettis.com/.

agricultural taxes for farmers. From 2004 to 2011, the government raised pensions for enterprise employees by 10 percent a year. During the eleventh five-year plan period (2005–2010), local governments increased minimum wages three times, by an average of 13 percent each time. The government has also raised the income tax threshold for individuals, from 800 yuan a month to 1,600 yuan in 2005, to 2,000 yuan in 2007 and again in 2011 to 3,000 yuan. In late 2012, the 18th Party Congress promised to double urban and rural household income between 2010 and 2020. In February 2013, after years of study and consultation, the State Council issued an opinion on income distribution reform, calling for an increase in the share of household income in the country's GDP and for wealth redistribution among groups and regions in the country.[5]

The Chinese government has also adopted policy measures to reduce precautionary household savings by expanding the scope and depth of welfare programs. A new social insurance law went into effect in 2011. Health insurance has been greatly extended, including in the rural areas. Pension plans have been widened to cover groups that were previously excluded, such as the urban unemployed and rural residents. The government has also invested in affordable housing for low-income groups. These measures have produced limited results. While the rise in the household savings rate has been halted in the last few years, the overall national savings have not dropped. This is because national savings also include corporate savings and government savings, the growth of which has kept national savings high. According to the World Bank, in 2012, China's gross savings still accounted for 51 percent of its GDP, among the top countries in the world, while its household consumption remained at the low level of 35 percent of the GDP, much lower than the world's average of 60 percent.[6]

As noted earlier, China's current account surplus declined in the aftermath of the GFC, largely due to sluggish demand in the international market and the giant stimulus program at home. While the external imbalance has been diminished, the internal imbalance of the Chinese economy has actually worsened. The massive investment made by the government through the stimulus program and beyond has led to serious overcapacity and debt (IMF 2013; Ahuja et al. 2012). If domestic consumption in China continues to stay low, there will be tremendous pressure to export products, rejuvenating large trade surpluses and again worsening the external imbalance.

POLITICAL OBSTACLES TO ECONOMIC REBALANCING

If Chinese policy makers have been aware of the dual economic imbalance and what needs to be done to rebalance the economy, why have their efforts to increase domestic consumption and reduce savings, investments and exports made such little headway over the last decade? The answer lies in the formidable political obstacles for change. They include the statist nature of Chinese nationalism as well as institutions and interests that are deeply entrenched in the existing model of development.

In the post-Mao era, the Chinese Communist Party (CCP) has made nationalism a new source of its legitimacy. The particular brand of nationalism cultivated by the CCP equates the well-being of the nation with China's power and prestige in the world

5 The text in Chinese can be found at http://news.xinhuanet.com/politics/2013-02/05/c_114625358_2.htm.

6 See http://wdi.worldbank.org/table/4.8.

(Zhao 2004; Gries 2004). Furthermore, largely as a result of modern Chinese history, contemporary Chinese nationalism differs from Western traditions of nationalism in that it strongly identifies with state power and state sovereignty rather than the notions of freedom and popular sovereignty (Wang 1996; Zheng 1999).

Chinese statist nationalism prioritizes state capacity over the livelihood of ordinary people. Until recently, this mentality led to China's enthusiasm for building up its surpluses in international balance of payments. When China's foreign reserves exceeded the symbolic threshold of US$1 trillion in 2006, many inside and outside the government cheered for this historical milestone. In the last few years, as China's reserves continued to rise — reaching an extraordinary level of US$3.8 trillion in 2013 — policy makers have become concerned about the cost and risks of the huge reserves. But there is still a widely shared view that a favourable balance of payment is part of China's comprehensive national power, its national competitiveness and its ability to ensure financial stability. Moreover, the government's approach to reducing the costs and risks of its huge foreign reserves has been to try to diversify its holdings by encouraging large state-owned enterprises (SOEs) to make direct investment overseas. The focus is still on enhancing the state's economic power.

Statist nationalism also goes a long way in explaining the government's favourable policy toward large SOEs, many of which are granted monopolistic or oligopolistic positions in key sectors of China's economy, such as energy, transportation, communications and finance. In 2012, of the 70 Chinese companies on the Fortune Global 500 list, 65 were state-owned. Some critics have expressed concern over the advancement of the state sector and the retreat of the private sector (*guo jin min tui*), with SOEs acquiring large numbers of non-state owned enterprises in recent years; however, the government has vigorously defended the SOEs as pillars of national power (Leng 2013).

Finally, statist nationalism has been used to justify the dramatic increase in government revenues. From the late 1990s to the present, Chinese government revenues grew at an astonishing rate of about 20 percent each year. In response to critics who denounced the concentration of wealth in the government's coffers, officials claimed that the government needed to have adequate fiscal power to implement macroeconomic policy, redistribute wealth and build up national defence.[7] In other words, what is good for the government is good for China.

In addition to the statist mindset, rebalancing efforts have also been constrained by entrenched institutions and interest groups. One prominent institutional underpinning of the existing model is the state-controlled financial system. State-owned and government-controlled banks dominate in China. They privilege SOEs at the expense of non-state enterprises in credit allocation. They suppress interest rates and, in effect, transfer wealth from households to enterprises (Lardy 2012). One estimate put the transfer in the neighbourhood of five to seven percent of GDP each year (Pettis 2011). This type of financial system has been a major source of the high investments by SOEs and of their extraordinary profits (i.e., corporate savings) at the expense of household consumption.

Another institutional pillar of the existing model is the large and bureaucratically dominated public finance system. At the national level, the main actors are the

7 See, for example, statement by the Minister of Finance Xiang Huaicheng (2011). Public discontent on this issue, as well as *guo jin min tui* mentioned earlier are indicative of the declining appeal of statist nationalism to ordinary citizens, but as an official ideology it continues to shape government policies.

National Development and Reform Commission (NDRC) and the Ministry of Finance (MOF). Although the National People's Congress is authorized to approve each year's budget, its function has been little more than that of a rubber stamp. It is not surprising that public finance has heavily tilted in favour of projects benefitting the government at the expense of social welfare. The allocation of the government's ¥4 trillion stimulus package after the GFC offers a good illustration. According to the plan made by the NDRC, the vast majority of funds were directed at investment in infrastructure. In contrast, social welfare spending only constituted eight percent of the package.[8] Moreover, China's public finance is highly fragmented: the central government accounts for about 30 percent of the government spending while the remaining 70 percent goes to the provincial and local governments. Most local government spending has even less transparency and accountability than the central government (Wong 2007). Local public spending often shows an investment and infrastructure bias because these projects advance officials' careers and enrich well-connected groups.

In recent years, local governments have increasingly relied on off-budget revenues from land transactions to finance their needs. As monopoly suppliers of land use rights, local governments are able to control the quantity, structure and timing of land supply. Their land-based financing has fuelled real estate investment and speculation. The rapid rise in housing prices has meant a significant reduction in household income available to purchase other types of goods and services, further dampening domestic consumption.[9]

Rebalancing China's economy would require institutional reform, including liberalizing the financial system and increasing public input in public finance. These measures have met strong resistance, because they would greatly reduce state control of the economy and undermine the interests of powerful political and economic groups. For instance, as noted earlier, in 2004 the government began to draft a plan for income distribution reform. It took nine years of consultation and study for the State Council to finally issue an opinion in February 2013. The document is reported to have gone through at least a half-dozen drafts, which diluted or abandoned the most important proposals because of opposition from SOEs and others (Davis 2012).

Although China does not have an open and competitive political system, it has, nonetheless, become more pluralistic. Interest groups both inside and outside the government have been on the rise and have been particularly active in trying to influence economic policies (Kennedy 2005; Steinberg and Shih 2012; He 2013). There are two types of actors with a great deal at stake in the policy debate over the growth model. Actors who have benefitted greatly from the existing model have strong motivations to oppose increasing domestic consumption at the expense of investments and exports. Many of them can be found in government agencies such as the NDRC, the MOF, the State Assets Supervision and Administration Commission, and

8 See www.caijing.com.cn/2008-11-27/110032337.html.

9 This problem is also closely related to the financial system. The illiberal nature of the financial system severely limits the investment options of Chinese households. Having little access to investment venues outside state-owned banks, many Chinese have poured their savings into the housing market. A recent national survey found that about 66 percent of family assets were in housing in 2013 (Bloomberg News 2014).

the Ministry of Commerce, as well as large SOEs and local governments in the coastal provinces. They are powerful and well connected in the policy-making apparatus. Actors who have suffered under the existing model have good reasons to support change. They include private entrepreneurs, labour and the general population as savers and consumers, who have relatively little influence and few resources under the current political framework. The power balance between these two sides overwhelmingly favours the opponents of reform. Without major political change, it will be difficult for economic rebalancing to proceed effectively.

LOOKING AHEAD

The new generation of Chinese leaders, headed by President Xi Jinping and Premier Li Keqiang, has been in office for about a year. Both Xi and Li have spoken eloquently about the need to deepen economic reform in China. The decision of the third plenum of the 18th Party Congress last November vowed to give market mechanisms a decisive role in allocating resources, adjust the role of the government in the economy, promote fair competition among all enterprises, reduce inequality and improve people's living standard. These initiatives, reiterated by China's leaders at the annual meeting of the National People's Congress in March 2014, speak directly to the existing development model's institutional problems. If implemented, they should go a long way toward rebalancing the Chinese economy. Some commentators have been greatly encouraged by these promises, declaring that China has finally begun to shift to a consumption-based growth model and that "the next China is now at hand" (see, for example, Roach 2013; Huang 2014).

There are indeed some signs that suggest that the new leadership is serious about pushing ahead with economic reforms despite strong political opposition. The recently formed the Central Leading Group for Overall Reform had its first meeting in January 2014. Headed by Xi, this group seeks to centralize decision-making power, presumably to counter the vested interests in various government agencies. For instance, it has been reported that the NDRC faces the prospect of losing considerable power in the new round of reform because it is so wedded to the investment-dominated development model (Martin 2014). Some observers believe that the recent purge of high officials in government agencies, large SOEs and provincial governments in the name of combatting corruption has been all about overcoming political obstacles to changing the development model (Pettis 2013b; Walter 2014).

The analysis in this policy brief cautions against too much optimism. After all, Chinese leaders and analysts have long been aware of the economic imbalance, well before it became an influential perspective among Western observers. The predecessors of the current leaders made an explicit commitment to shift to a consumption-driven economic growth model some years ago. But the ideological, institutional and political obstacles proved to be too great to overcome.

Some observers argue that China's authoritarian regime has been able to make tough decisions in the past, unlike governments in more democratic countries, which tend to avoid painful reforms due to the opposition of powerful constituents. They wonder if China can do it again, putting up with short-term pains to bring about the necessary change to the economy (see, for example, Zakaria 2013). This may be wishful thinking. While the Chinese state remains authoritarian vis-à-vis the society, it is highly fragmented within, lacking the capacity for fundamental economic and social transformation (Howell 2006; Pei 2009). It is not clear how much the top leaders can manage to centralize decision-making power, if they can achieve consensus among themselves and how they can overcome the opposition of vested interests of large portions of the political and economic elite. Ultimately, the political system has to change to break down the powerful forces against further reform and to empower groups that have been so deprived by the existing development model. Thus far, however, the new leaders of China have not indicated any interest in changing the political system. Without political reform, Xi and Li are unlikely to be much more successful than their predecessors in rebalancing China's economy.

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