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Rebalancing the world economy: China

The spend is nigh

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The second article in our series on global rebalancing asks whether China can reduce its trade surplus by consuming more

A REBALANCED global economy requires America to consume less and save more. That means the world's three big surplus economies—China, Germany and Japan—will have to save less and spend more. None is under more scrutiny than China, whose vast current-account surplus has been fingered by some as the ultimate cause of the financial crisis. The case against China is exaggerated but a surplus of more than $400 billion in 2008, or 10% of GDP, was clearly too big. Can China right its trade imbalances, and if so, how will it achieve rapid growth in future?

The good news is that the surplus is already shrinking. The strong rebound in China's economy in the second quarter—pushing GDP 7.9% higher than a year ago—came entirely from domestic demand. This sucked in more imports, while exports continued to slump. China's merchandise trade surplus narrowed to $35 billion in the same quarter, 40% down on a year earlier. Yu Song and Helen Qiao of Goldman Sachs calculate that the decline is even more impressive in real terms (adjusting for changes in export and import prices), with the surplus shrinking to less than one-third of its level a year ago (see chart 1). They even suggest that a monthly trade deficit is possible within the next year.

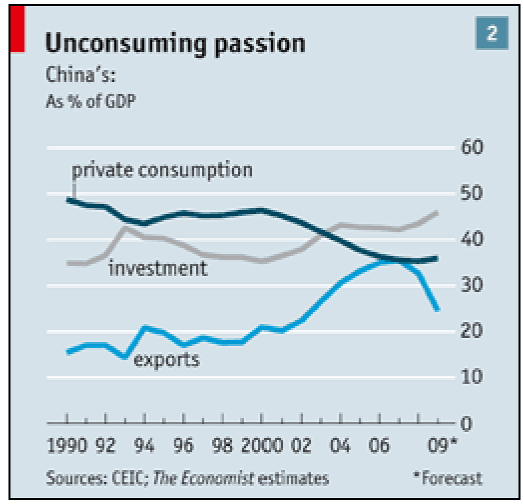
Another way to look at the huge swing in China's trade is that net exports (exports minus imports) contributed 2.6 percentage points of the country's GDP growth in 2007, but shaved almost three points off its growth in the first half of this year.

Most economists think that China's trade surplus will remain large. The jump in imports in the second quarter included heavy stockpiling of commodities, which will not last; copper imports, for example, were 150% higher than a year ago. Yet the underlying surplus is clearly shrinking. Paul Cavey of Macquarie Securities forecasts that China's current-account surplus will fall to under 6% of GDP this year and 4% in 2010, down from a peak of 11% in 2007. Exports amounted to 35% of GDP in 2007; this year, reckons Mr Cavey, that ratio will drop to 24.5%.

On the surface, therefore, China is fulfilling the long-standing demand of Western governments that it shift its engine of growth from exports to domestic demand. Thanks to the biggest fiscal stimulus and loosening of credit of any large economy, China's real domestic demand is likely to grow by at least 10% this year. In fact, the popular perception that China has always relied on export-led growth is rather misleading. Its current-account surplus did soar from 2005 onwards but until then was rather modest. And over the past ten years net exports accounted, on average, for only one-tenth of its growth.

The problem is more that the mix of domestic demand between consumption and investment is unbalanced, and becoming even more so. In 2008 private consumption accounted for only 35% of GDP, down from 49% in 1990 (see chart 2). By contrast, investment had risen from 35% to 44% of GDP. This year the bulk of the government's stimulus is going into infrastructure, further swelling investment's share. Chinese capital spending could exceed that in America for the first time, while its consumer spending will be only one-sixth as large. This is China's most glaring economic imbalance.

Spending lots of money on building railways, roads and power grids is the most effective way for the government to prop up demand in the short term—especially since China, as a poor country, needs better infrastructure. However, the pace of investment is unsustainable. Even before this year's infrastructure boom capital spending was too great, causing many economists to worry about excess capacity and the risk that bank loans could sour.



China deserves credit for the speed with which it responded to the global downturn. Now it needs to focus on structural reforms not just to keep domestic demand growing strongly and to reduce its trade surplus further, but also to derive more of its growth from consumption and less from investment.

Before exploring how China can do so, it is important first to clear up a misunderstanding. It is often argued that China runs a current-account surplus because its consumer spending has been sluggish. On the contrary, China has the world's fastest-growing consumer market, increasing by 8% a year in real terms in the past decade. Retail sales have leapt by 17% in real terms in the past 12 months, although this figure may be inflated by government purchases. Even so, China's consumer spending has grown more slowly than the overall economy. As a result consumption as a share of GDP has fallen and is extremely low by international standards: only 35%, compared with 50-60% in most other Asian economies and 70% in America.

Economists disagree about the main reason why the consumption ratio has fallen—and hence about the best way to lift it. The most popular explanation is that Chinese households have been saving a bigger slice of their income because of an inadequate social safety net. They have squirrelled away more money to cover the future cost of health care, education and pensions. According to Eswar Prasad, an economist at Cornell University, the saving rate of urban households has jumped from 20% to 28% of their disposable income over the past decade. After exploring all the possible causes, he concludes that uncertainty about the private burden of health care and education is indeed the main culprit. The effect has been worsened by an undeveloped financial system, making it hard for households to borrow.

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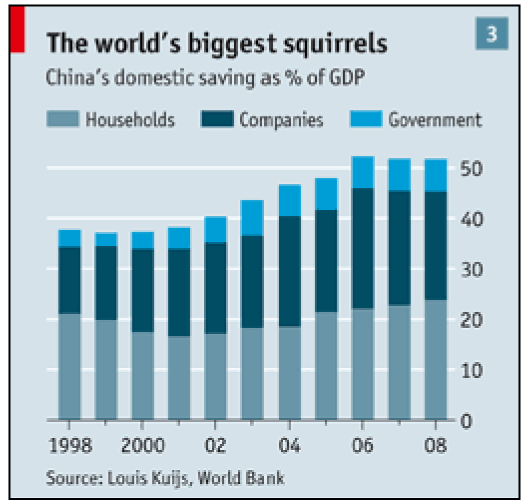
The Beijing government is acting: it doubled spending on health care, education and social security between 2005 and 2008. But the total amount remains low at only 6% of GDP, compared with an average of around 25% in OECD countries. This year the government has increased pensions coverage and payments to low-income households. It has also pledged to provide basic health care for 90% of the population by 2011, although the new spending appears to be less than 0.5% of GDP each year. If such measures ease households' worries about future health care, they could encourage them to save less. But it will take years for them to have much effect on consumer behaviour.

Slicing up saving

More to the point, an inadequate welfare state does not fully explain why consumption has fallen as a share of GDP. The first niggle is that most workers lost their state-provided health care and education almost a decade ago, after the reform of state-owned firms, so this cannot really explain why saving has continued to rise more recently. Louis Kuijs, an economist at the World Bank in Beijing, suggests that the extra saving may owe as much to greater income inequality as to the lack of a welfare state. Rich people save a lot more and their numbers have increased.

A second flaw in the thesis is that although urban households have been saving more, rural households have become less thrifty over the past decade. As a result China's average household-saving rate has risen more modestly. Mr Kuijs calculates that total household saving has risen from 21% of GDP in 1998 to 24% in 2008. Households accounted for only one-fifth of the increase in total domestic saving over the period. Most of the increase in saving came from companies (see chart 3).

This matters for two reasons. First, if anyone saves too much, it is companies, not households. Second, you need to look elsewhere for the cause of China's falling consumption ratio. The drop in consumer spending as a share of GDP over the past decade has been almost four times larger than the rise in household saving.



The more important reason why consumption has fallen is that the share of national income going to households (as wages and investment income) has fallen, while the share of profits has risen. Workers' share of the cake has dwindled because China's rapid growth has generated surprisingly few jobs. Growth has been capital-intensive, focusing on heavy industries such as steel rather than more labour-intensive services. Profits (the return to capital) have outpaced wage income.

Capital-intensive production has been encouraged by low interest rates and by the fact that most state-owned firms do not pay any dividends, allowing them to reinvest all their profits. The government has also favoured manufacturing over services by holding down the exchange rate as well as by suppressing the prices of inputs such as land and energy.

Simply urging households to spend a bigger slice of their income will not be enough to shift China's growth towards consumption. Beefing up the welfare state is important but policy also needs to focus on how to lift household income and reduce corporate saving, says Mr Kuijs. Making growth more labour-intensive will require lots of difficult reforms. China needs financial-sector liberalisation to lift the cost of capital for state-owned companies and improve access to credit for private ones, especially in services. Higher deposit rates would also boost household income. Distortions in the tax system which favour manufacturing and barriers to private-sector participation in some service industries should be scrapped. State-owned firms ought to be forced to pay bigger dividends. The prices of subsidised industrial inputs should be raised. Land reform and the removal of restrictions on migration from rural to urban areas would also help to lift incomes and thus consumption.

China has barely started on these important reforms. That may be because they involve much harder political decisions than creating a welfare state. They require the government to loosen its control over the economy, something which Beijing will do slowly and reluctantly.

Last but not least, China needs to allow its exchange rate to rise. This would lift consumers' real purchasing power, discourage excessive investment in manufacturing and help to reduce the trade deficit further. It would also alleviate the risk of a protectionist backlash abroad. From July 2005 (when China abandoned its dollar peg) to February 2009, the yuan rose by 28% in real trade-weighted terms, according to the Bank for International Settlements. But alarmed by the collapse of exports, China has virtually repegged the yuan to the dollar over the past 12 months. As the greenback fell this year, it dragged the yuan down with it. Since February the yuan's real trade-weighted value has lost 8%.

Economists disagree about the extent to which the yuan is undervalued. In the IMF's "Article IV" assessment of China, published on July 22nd, officials were split over whether the currency was "substantially undervalued".

Morris Goldstein and Nicholas Lardy, of the Peterson Institute for International Economics, have done some of the most extensive work on China's exchange rate. In a new study, they estimate that the yuan is undervalued by 15-25%, based on the adjustment needed to eliminate the current-account surplus.

The American government has softened its demands for revaluation, largely because it needs China to keep buying Treasury bonds to fund its own stimulus spending. At the Strategic and Economic Dialogue meeting between American and Chinese officials on July 27th and 28th in Washington, DC, the yuan's exchange rate was barely discussed. However, the case for appreciation remains strong.

China's recent efforts to boost domestic spending have helped to maintain robust growth and reduce its trade surplus. But excessive levels of investment are not a recipe for sustained rapid growth. Unless it is prepared to embrace difficult structural reforms and to allow the yuan to climb, China's commitment to rebalancing will remain half-hearted. In the long run that will be bad news for China itself as well as for the rest of the world.

Video: See the changing face of China's economy at: Economist.com/videographics