SPECIAL REPORT

TD Economics

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ASSESSING CHINA'S QUEST FOR ECONOMIC REBALANCING

Highlights

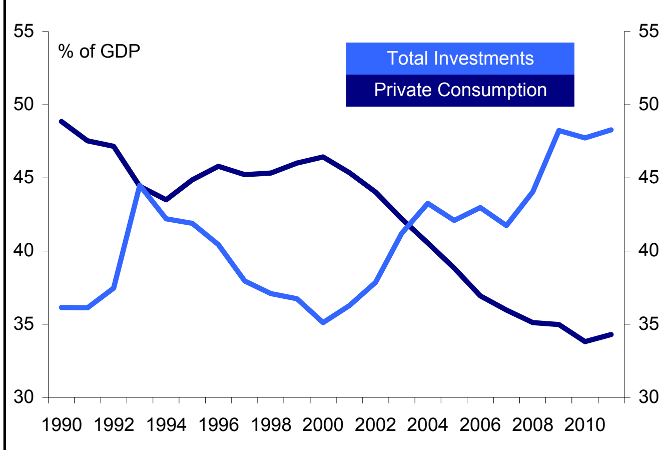
- Chinese spending on fixed investments have climbed to 48% of GDP from roughly 35% a decade ago. This has come at the expense of household consumption, which has dropped to around a third of GDP.
- Chinese authorities have introduced a number of policy initiatives to address this growing internal imbalance.
- However, achieving their objectives would require a sizeable growth outperformance of consumption over investment.
- This would, in turn, call for income redistribution and a change in saving patterns; none of which will happen unless the social safety net is strengthened.

During the last three decades, China's economy has grown at an average annual rate of 10.3%. In recent years, in particular in the aftermath of the 2008 financial crisis, the Asian country has relied heavily on fixed investments to drive such high rates of economic growth. As a result, spending on fixed investments climbed as a share of GDP from 35% in 2000 to 48% in 2011. This impressive level of capital accumulation has been possible thanks to China's high saving rate, which has also allowed the country to be a net provider of funds to the world. Indeed, over the last two decades, China's current account surplus has averaged 3.4% of GDP.

Naturally, this prolonged strong investment and external surplus cycle has come at the expense of aggregate consumption, which has fallen sharply as a share of GDP. Attentive to the economic risks associated with these growing imbalances, Chinese authorities have made it a priority of their 12th Five-Year Plan to steer the country's economic growth strategy away from fixed investments and towards private consumption.

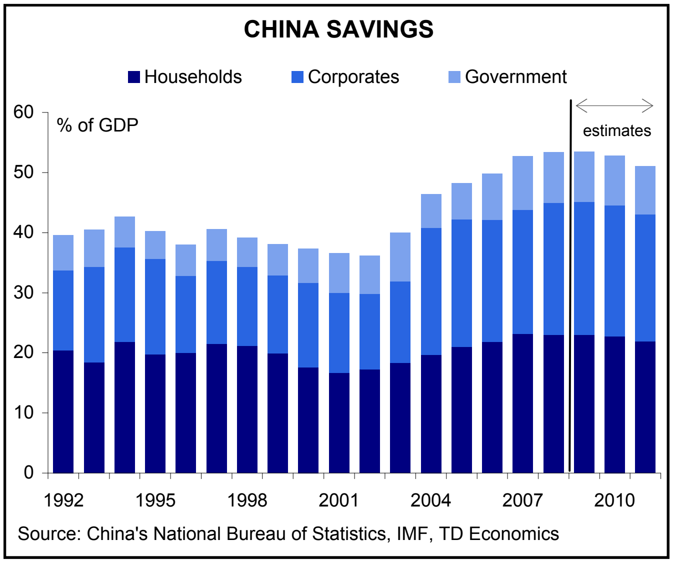
In this report we review the main factors that have led to high savings and investments in China and assess the prospects for economic rebalancing. Our analysis shows that achieving the desired outcome without causing a drastic deceleration in economic activity would require private consumption to outgrow fixed investments by around 8 percentage points annually for several years; a formidable challenge if one considers the changes to both income distribution and saving patterns that would have to occur to secure that outcome. In addition, we argue that even

CONSUMPTION AND INVESTMENTS



Source: China's National Bureau of Statistics, IMF, TD Economics

Martin Schwerdtfeger, Senior Economist, 416-982-2559



if the country succeeds in transitioning to an economic growth model in which consumption and investments play more even roles, this would not necessarily translate into a reduction of China's external surplus.

High savings across the board

One of the characteristics that distinguishes China from other countries with high saving rates such as India, Korea, and Japan, is that all of its economic sectors – households, corporations, and the government alike – have shown high saving rates in recent years. In particular, corporations have been responsible for more than half of the increase in total savings since early 2000s, whereas households have contributed about a third of the overall savings increase. We will review next the main elements that have shaped Chinese saving habits in recent years.

Household savings

Chinese households managed to increase their savings from roughly 17% of GDP in 2001 to 23% of GDP in 2008 even though their share of gross national disposable income declined from 70% to 57% over the same period. To achieve that outcome, Chinese households had to raise their saving rate by roughly 12 percentage points from 27% in 2001 to 39% in 2008 – the latest available data. Several concurring factors explain these dynamics.

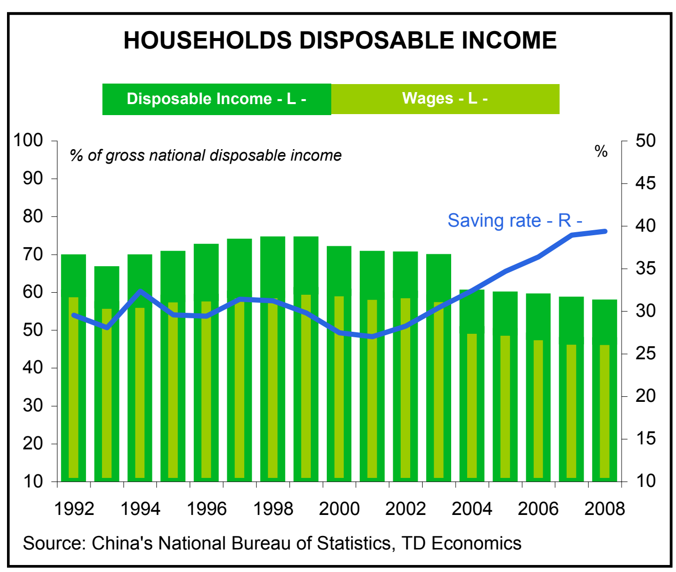
First, the fall in households' share of total income has been primarily attributable to the low labor intensity of the sectors that have driven China's economic expansion in recent years. This has caused a decline in the ratio of wages-to-total income from around 60% in 2000 to 47% in 2008.[1] To a lesser extent, the lower household share can also be traced back to a decline in investment income – due to financial repression – and to diminished net income transfers from the government.

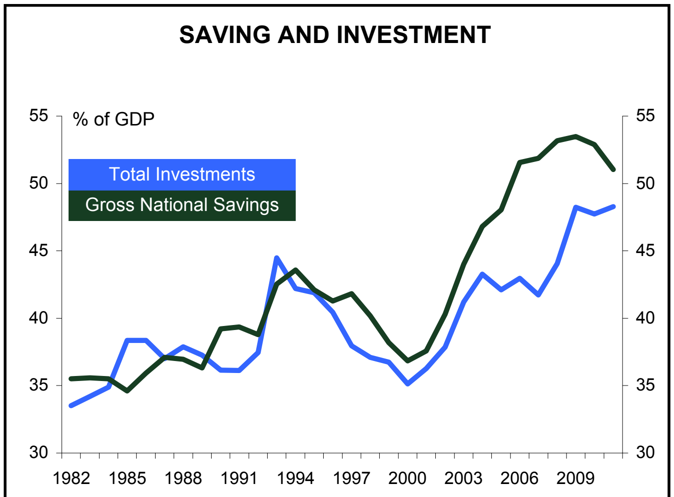
Second, both the pension reform in 1997 and the corporate restructuring over 1995-2005 had a material impact on households' saving behavior. Those two institutional reforms eroded the social safety net, lowering the pension and benefits payments households expected to receive in the future. This prompted Chinese families to boost their precautionary savings.

Third, a significant drop in the dependency ratio caused by the one-child policy permitted greater savings, especially among younger households. Other factors, such as the rapid population ageing process also played a role in raising households' propensity to save.[2]

Corporate savings

As to higher corporate savings, they also resulted from several economic and institutional factors. A low-dividend payment policy for most state-owned enterprises, in combination with negative real interest rates, have translated into a low cost of capital for Chinese firms. This has boosted their profit margins and savings. In addition, corporate reforms initiated in the mid-1990s yielded efficiency gains that led to improved margins and savings. Lastly, many Chinese firms have benefited from underpriced land, water, and energy costs, which jolted their profitability, and at the same time, generated incentives to invest in capital





Source: China's National Bureau of Statistics, TD Economics

intensive activities such as manufacturing, real estate, and infrastructure projects.[3]

Government savings

Turning to the government sector, increased savings resulted from higher government income and relatively constant government consumption as a share of GDP. Strong economic growth, the 1994 tax reform,[4] rising sales of land use rights, and greater social welfare contributions from both households and corporations, have all led to a significant rise in government income over the last two decades.

Furthermore, although the larger share of rising fiscal revenue is appropriated by the central government, the bulk of the social spending burden rests with the less-well funded local jurisdictions. This has underpinned the government's tendency to save a rising portion of its income. In turn, local government officials favor infrastructure projects over providing additional public services, as the former are more tangible achievements that help to promote their political careers.[5] The combination of these elements has yielded higher government savings.

Chinese authorities seek change in growth pattern

Thus, the interaction of economic, social, institutional, and political factors generated high savings and investment in China. Well aware of the roots of the country's growing imbalances, Chinese authorities designed the 12th Five Year Plan to tackle many of these issues. Its main objectives are to raise household incomes, alongside an expanded social safety net, and to increase the relevance of the service sector in the domestic economy. This comes on top of other policy measures introduced in recent years, such as changes in the dividends policy for state-owned firms, changes in the prices of production factors, the development of capital markets, and financial reform. The latter has included a gradual softening of the foreign direct investment regime, and most recently, the widening of the renminbi trading band. Chinese Premier Wen has indicated further progress will likely include making the banking system operate under a market-based interest rate pricing environment. This will eliminate the recurrence of negative real interest rates being paid on bank deposits.

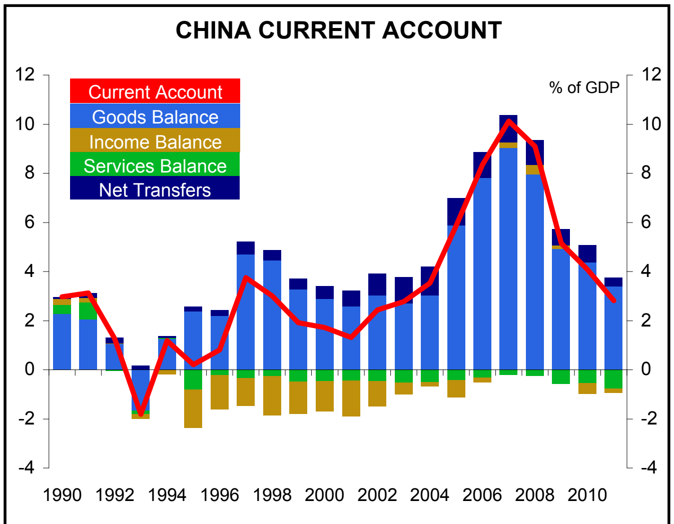
Whether these policy initiatives will prove sufficient will depend on how they are implemented. This always comes with a good deal of uncertainty, especially in this case, given the sizeable growth differential between consumption and investment that would have to be engineered to achieve the desired rebalancing. Below we conduct a simple growth accounting exercise to illustrate this point.

Economic rebalancing, the good way

Assume that, in line with the growth target set by the 12th Five Year plan, Chinese GDP growth slows down smoothly from its current level to 7.5% and remains there for the next ten years. Against that backdrop, assume we want to have household consumption rising to 46% of GDP and the share of fixed investments falling to around 35% of GDP within that ten-year span. In addition, assume both the net trade balance and government consumption remain at around 2% and 15% of GDP, respectively. Under these assumptions, achieving the desired consumption-investment mix within ten years would require private consumption to outpace real GDP growth by 3.5 percentage points annually while fixed investments grow at half the speed of GDP. This is hard to envisage given that it would contrast sharply with the typical dynamics generally displayed by these two macroeconomic aggregates.

Furthermore, if we assume that the households' saving rate remains unchanged at around 39%, those levels of consumption would require household disposable income to rise as a share of national disposable income by around 20 percentage points to 77%. On the other hand, if the saving rate falls back to its lowest level of recent years –around 27%– then household disposable income would only have to rise by 7.5 percentage points to 64.5%.

Securing a transition of this sort without any hiccups would prove a remarkable challenge. It is one thing to prompt state-owned firms and local governments to invest



Source: IMF, TD Economics

in infrastructure aided by plentiful bank lending as Chinese authorities successfully did in 2008-2009. It is a very different thing to implement such a redistribution of income in favor of households, and to convince them that the changes would be long-lasting, so that they actually spend more and save less. This is where the enhancement of the social safety net will prove critical. But the rebalancing process is bound to exacerbate conflicts not only between households and corporations, but also within the different layers of government. That is why implementation of the reforms proposed under the 12th Five Year Plan will prove an arduous endeavor.

Will internal rebalancing lead to a narrowing of China's external surplus?

The answer is, not as much as you might think. Even if China succeeds in its quest for internal rebalancing, this may not translate into a surge in consumer goods imports, let alone a further narrowing of its current account surplus. First, China is still a relatively minor importer of consumer goods, accounting for only around 2% of global demand for these goods. Moreover, since 1995, China's share in global consumer goods imports has increased less than its share in global consumption.[6] To revert the latter trend, not only would domestic demand for consumer goods have to increase, but so would the desire to satisfy that demand with foreign items.

Second, the massive expansion in domestic manufacturing capacity that took place in recent years, in combination with the relocation of traditional, lower value-added manufacturing activities inland, might make it even more difficult for foreign producers to reach Chinese consumers.

Third, as income per capita grows, consumption of services would expand faster than spending in consumer goods. All these elements will limit the impact of rebalancing of domestic demand on China's current account surplus.

Lastly, a deceleration in the pace of physical capital accumulation will also weigh on Chinese imports, further limiting the reduction on the country's external surplus. In fact, a significant portion of the reduction in China's trade surplus since 2007 has been explained by the surge in imports of capital goods and minerals associated to the investment surge. If investment slows down, so will imports and with them, the reduction in the country's external surplus.

Final Remarks

In this report we have reviewed the main factors that have caused a saving and investment surge in China in recent years. We also looked at the growth dynamics that would have to play out between consumption and investment spending to secure a rebalancing of the Chinese economy while avoiding a severe economic slump. Our analysis shows that private consumption would need to outgrow fixed investments by around 8 percentage points annually for at least a decade. This could require a significant income redistribution, if Chinese households' saving habits were to remain unaltered. If households' saving rates were to drop, the income redistribution needed would be more manageable. At last, we presented a few arguments that suggest that, even if successful, domestic rebalancing would not necessarily yield a reduction in China's current account surplus.

Martin Schwerdtfeger
Senior Economist
416-982-2559

Endnotes:

1 Guo, K., and P. N'Diaye, 2010, "Determinants of China's Private Consumption: An International Perspective," IMF Working Paper No. 10/93.

2 Ma, G., and W. Yi, 2010, "China's high saving rate: myth and reality", BIS Working Papers No. 312.

3 Geng, N., and P. N'Diaye, 2012, "Determinants of Corporate Investment in China: Evidence from Cross-Country Firm Level Data", IMF Working Paper No. 12/80.

4 In 1994 the Chinese government launched a comprehensive tax reform that included a formal tax assignment system whereby taxes are divided into three categories: central taxes, local taxes, and shared taxes between central and local governments. It also brought the corporate profit tax at the uniform rate of 33% for all enterprises, state and non-state alike, and replaced an old indirect tax by a value added tax (VAT).

5 Ma, G., and W. Yi, 2010, op cit.

6 "Managing Spillovers and Advancing Economic Rebalancing", IMF World Economic and Financial Surveys, Regional Economic Outlook, Asia and Pacific, April 2012.