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China's Next Leap Forward—Economic Rebalancing and Structural Adjustment (Part 4)

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In Part 3, we highlighted the challenges facing China's effort to make the economy more consumer-driven, and analyzed the structural policies needed to achieve that goal. We argued that such a shift would require a break from the current growth model, which is inherently investment-intense. In this concluding installment, we focus on China's investment policy and the fundamental changes needed to boost capital efficiency.

Put simply, we believe the task of controlling investment growth in China in the coming decades will be even more daunting than that of boosting consumption. While the country has benefited tremendously from rapid investment-driven growth it remains half-urbanized, with an economy with readily available liquidity. In such an environment, Beijing faces an uphill battle to reduce investment intensity effectively.

Scenario Analysis on Rebalancing

A simple calculation shows the scale of the problem. To recap, China's average real GDP grew 11.7% a year over the past 10 years, with private consumption growing 9.2% a year on average and fixed investment at a staggering 15.1% rate. These contributions to economic growth resulted in the consumption ratio falling to 36% of (real) GDP in 2009 and the investment ratio jumping to 46% (**Display 1, next page**).

If we assume China continues to deliver a decent GDP growth rate of 7% a year in the next 10 years, while keeping consumption and investment ratios at their 2009 levels, consumption will need to grow 7% a year and investment will need fall by half—also to 7% a year.

If Beijing targets a five percentage point rise in the consumption ratio to 41% (from 2009 levels) and a five percentage point drop in the investment ratio by 2020, it will require consumption growth of 8.3% a year but a decline in investment growth to just under 6% a year. Similarly, if the Chinese leadership sets a more aggressive target of, say, a 10 percentage point rise in consumption and the same magnitude of decline in investment, the required investment growth will drop even further, to around 4.5% a year.

Japan's Experience

Although the last scenario looks aggres-

sive, Japan was able to achieve an even more pronounced result during its economic transformation in the 1970s (**Displays 2 and 3, next pages**). From 1970 to 1980, Japan's consumption ratio jumped seven percentage points from the trough, to 60% of GDP, while the investment ratio plummeted 14 points to 54%. Real annual investment growth was cut by half from an average 21% during the 1960s to 11% in the following decade, while consumption growth remained at 14% a year during the 1970s (little changed from 15% annually in the 1960s). During the 1980s, investment growth slowed even further to 6% a year but—as Japan's asset bubble burst—so did consumption growth.

A point to note is that Japan's per capita GDP level during its 1970s economic transformation was similar to China's today (at around US\$3,500–US\$4,000 in nominal terms) but its urbanization rate, at around 70%–80%, was much higher than China's, which is currently 50%. Also, robust consumption growth in Japan was spurred by a threefold increase in employees' income during the 1970s. In addition, the sharp fall in both investment growth and the investment ratio was a result partly of improved capital efficiency and partly the effect of rising wage costs and a sizable yen revaluation (the yen appreciated against the US dollar by a

Display 1
Slower Investment Growth Is Required

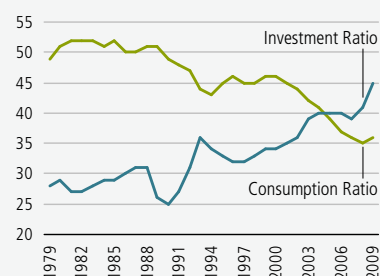
Scenario Analysis on Rebalancing

	GDP	Private Consumption	Fixed Investment
2009			
Share of Real GDP (%)		36	46
Real Growth per Annum in Past 10 Yrs (%)	11.7	9.2	15.1
By 2010			
Share of Real GDP (%)		36	46
Real Growth per Annum in 2010–2020 (%)	7.0	7.0	7.0
Share of Real GDP (%)		41	41
Real Growth per Annum in 2010–2020 (%)	7.0	8.3	5.9
Share of Real GDP (%)		46	36
Real Growth per Annum in 2010–2020 (%)	7.0	9.4	4.6

Source: CEIC Data and AllianceBernstein estimates

Display 2
China's Investment Ratio Will Need to...

China's Consumption and Investment Ratios



Source: CEIC Data and AllianceBernstein estimates

cumulative 20% during the 1970s and another 55% during the 1980s). This, in turn, triggered the significant flow of Japan's outward investment to lower-cost destinations during this period.

The Lesson for China

Japan's experience suggests that rising wages, currency revaluation and improved value-added production and efficiency will be important to China's effort to rebalance domestic demand from investment to consumption. In our view, however, China faces a headwind not faced by Japan four decades ago: the investment required for the next stage of China's urbanization remains significant, particularly for inner cities in the western regions. Infrastructure and property investment, which account for some 35% of total investment, are likely to remain significant for decades to come. Investment in the central and western region has been growing substantially and accounted for 53% of total investment in 2009—a 10 percentage point jump over the past five years—and has already surpassed that in the eastern coastal region.

Energy and Resources Conservation

China's goal to improve energy efficiency will also have a mixed impact on future investment, as the country will need to invest substantially (in nuclear power, hydroelectricity, wind turbines, etc.) to achieve its efficiency target. At the

Copenhagen Climate Summit in 2009, China announced a self-imposed target of reducing total energy consumption per unit of GDP by a cumulative 45% from the 2005 level by 2020. This is a further 25% on the 20% reduction already set in China's Eleventh Five-Year Plan (2006–2010). Drawing on published statistics, we estimate that China has cut energy consumption relative to GDP growth by about 15.5% since 2006, and we think Beijing will probably miss its 20% target only marginally by the end of the current five-year plan (**Display 4, next page**).

The important point here is that even if China achieves its 45% reduction target by 2020, it will rise from its current status as the world's least efficient energy user to around average—a level similar to that of Thailand or Indonesia today. Its efficiency will still be half that of the US and more than three times lower than that of the most efficient energy user, Japan.

Beijing has been trying to reduce exports of resource-intensive products by cutting export VAT rebates to manufacturers. The subsidy, which amounted to 2% of GDP in 2009, enabled many otherwise loss-making exports to generate profits and thereby continue to attract investment from the private sector and local government. The government has also tightened regulations on heavy industrial investment, where new

capacity must be offset by the retirement of old capacity. A frequently occurring problem in this respect is that local governments have tended to add capacity faster than retiring it. In our view, unless the criteria for promoting local officials is changed from how well they have developed their areas to how much they have saved on energy and resources, this problem will remain a major challenge to the central government's investment guidelines.

The Importance of Adding Value

In Part 1 of this series, we argued that China's incremental capital-to-output ratio (its efficiency in the use of capital to generate economic growth) is low by international standards at this stage of its economic development. From a macroeconomic point of view, if China could continue to deliver robust GDP growth with a lower investment ratio (as discussed in the scenario analysis accompanying Display 1) it would by implication use capital more efficiently. In other words, the same unit of investment would have a much higher multiplier effect on the entire economy through the effect of boosting profits, incomes (and thus consumption) and export values. Improvements in value-added production and productivity are therefore vital to China's transformation.

While China's services and financial sectors

are still in an early stage of development, the country excels at manufacturing processing, although it continues to perform poorly on product design and creation. In manufacturing assembly, value-added production has improved noticeably over the past 10–15 years, from the early dominance of cheap products, like clothing, textiles, toys and plastic goods, to today's major industries, such as electronics, telecommunications and specialized equipment and machinery. Changes in the supply side of the economy can be effective at accelerating value-added production. For China, these changes include the higher cost of labor as the labor supply tightens more noticeably, higher energy and commodities costs as state subsidies are reduced, higher land prices as urbanization continues, and a higher cost of capital (the current one-year lending rate is 5.3%) to a level which is more aligned to nominal GDP growth (around 13% year on year in 2010).

Supply-Side Pressures

With regard to labor and wages, which we discussed in Part 3, we think labor compensation will increase more significantly only if Beijing allows unions greater collective bargaining power and changes the dividend payout structure of state firms. On energy and commodity pricing, China's onshore-offshore price gaps for many products (crude oil, fuel, steel, etc.) have already narrowed substantially, while

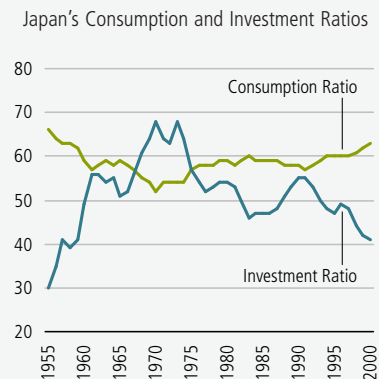
electricity tariffs and water usage charges will also rise over time. Land prices have increased markedly, and the government's current main focus is to prevent an asset bubble.

Indeed, it is evident that all the changes described above have begun to contribute to the transformation or upgrading of production: manufacturers in areas with the most acute labor shortages or rising production costs (such as Guangdong province) have started to extend their production into lower-cost locations in the hinterland or partner with firms in inner cities to maintain their competitive edge. This process will only accelerate and the endgame will be higher production value-added along the coastal regions.

Remaining Challenge

The change to a more realistic capital pricing structure to screen out inefficient investment will probably be a much more difficult task, given the dominance of state banks in the financial system. This will be a tough area to crack especially in view of the fact that the modus operandi of China's monetary policy is to target the quantity of money—a process in which the state has a strong influence on how credit is allocated to specific sectors (interest-rate adjustments tend to be a secondary monetary tool). Success in this area will require a genuine institutional change in monetary policy.

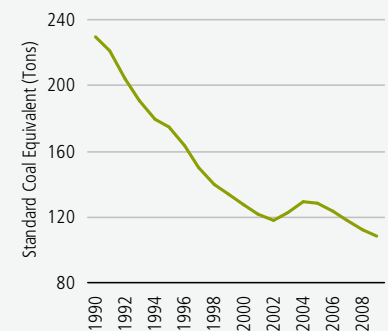
Display 3
...Resemble Japan's During 1970s Transformation



Source: CEIC Data and AllianceBernstein estimates

Display 4
Energy Efficiency Improves

China's Energy Consumption per Million RMB of GDP at 2005 Prices



Source: CEIC Data and AllianceBernstein estimates

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