

ECONOMICS: ASIAN PERSPECTIVES—JULY 2, 2010

China's Next Leap Forward—Economic Rebalancing and Structural Adjustment (Part 1)

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In the first of a series of analyses of potential structural changes in the Chinese economy, we look at the shift in policy away from high savings and investment. We conclude that this next “great leap forward” for China is going to throw up serious challenges for the leadership, making the road ahead a bumpy one.

The restructuring and rebalancing of the economy has become a hotly discussed and debated topic even among Chinese policymakers these days. This marks a big change from as recently as two years ago, when the policy awareness of this subject was incredibly low in China. This is hardly surprising given that, over the 30 years before the global crisis in late 2008, the main thrust of the Communist Party's development strategy was to create jobs, which were crucial to creating social and political stability and, ultimately, the consolidation of one-party rule.

A New Development Strategy

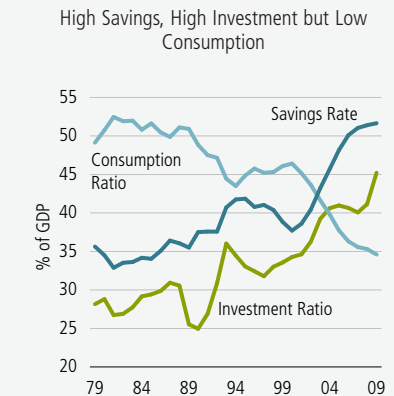
But China's policy focus has changed. In our view, there have been several key structural trends that have come together to prompt this shift in the country's development strategy.

Most importantly, creating jobs is no longer in itself a guarantee of social stability. The urgency is now on resolving the growing income disparities between rural and urban dwellers, between those

living in the hinterland and in the coastal regions and between blue and white collar workers. The increasing number of wage disputes and strikes in recent years has been a wake-up call for the leadership.

As the pool of surplus labor starts to shrink (even though, in our opinion, there remains plenty of room to improve labor participation), the priority is shifting from job growth to improving the standard of living, alongside a more balanced income distribution structure to deal with income inequality. This is crucial for social cohesion in a country where the leadership strives to create a “harmonious society.” Income redistribution is the necessary next stage of China's next leap forward along the road mapped by former paramount leader Deng Xiaoping when he launched the Open Door Policy in the late 1970s. Among the other objectives of that strategy was to allow a minority to get rich first. Arguably, that mission has been overachieved and the leadership is now having to deal with the resulting problems.

Display 1
Structural Trends in China's Economy



Source: CEIC Data and AllianceBernstein estimates

This change in the main thrust of development strategy will inevitably result in a rethinking of many other key policies, which we will now look at.

High Savings and Investment Model No Longer Sustainable

China's economic model based on high saving (52% of GDP in 2009) and high investment (45% of GDP) is no longer sustainable (**Display 1**). Nor has it been particularly efficient. This is demonstrated in **Display 2 (next page)**, which uses our estimation of incremental capital output ratios to compare China with other, mainly Asian, nations during their growth phases. This shows China is marginally more efficient in using capital investment to

generate economic expansion than Indonesia and India have been, but is outshone by what the Four Little Dragons (Hong Kong, Taiwan, Korea and Singapore) achieved. Also, China is much more inefficient than Japan was during its equivalent phase from the 1950s to the 1970s and the US from the 1940s to the 1960s.

There are many causes for China's high and rising investment rate. Some commentators have cited the underpricing of capital and artificially low interest rates as prime factors. We think, however, that rapid urbanization (from an almost totally agrarian society before economic reforms started thirty years ago) and massive investment in infrastructure and property development have been key driving forces. The high reliance on exports along the coasts, combined with an abundant supply of migrant workers, have also boosted manufacturing investment in China. They have helped transform the country into the world's factory for consumer and capital goods.

The Benefits of Adding Value

The tightening labor supply and rising costs in the coastal regions require China to make greater efforts to move production up the value-added ladder. This process will in itself boost wages and hence the standard of living. It will also provide a more forceful push to China's "Go-West" development policy as low-margin and labor-intensive production moves inland. And, as the next leg of China's urbanization (the urbanization rate was about 50% in 2009), it will raise the overall standard of living and consumption levels as rural dwellers migrate to cities and thereby increase demand for services, healthcare and education, etc.

Spending the Savings

China's over-saving behavior also has to change if the country is to meet its new economic goals. The flip side of a reduction in the savings rate is a reversal of the falling consumption ratio, which

currently stands at around 35% of GDP. Of the 50% savings rate in China, about 25% is household saving, 15% relates to the corporate sector, while the government accounts for 10% or slightly less. So, the important change has to be for Chinese households to increase their propensity to consume, but without excessive borrowing. This will require tremendous efforts by the state to remove the need for "precautionary" saving by households. It will require the implementation of a comprehensive national pension system and the provision of adequate social welfare, healthcare and education to inject a stronger sense of personal financial security.

The External Surplus

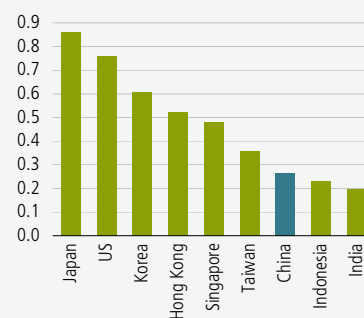
In terms of national income accounting, China's savings equal investment plus its external surplus. Thus a lowering of the savings rate would require a drop in the investment ratio or a fall in net exports, or both. Any reduction of China's external surplus would be a political issue, but we also sense that Beijing is increasingly coming to believe that the accumulation of further massive external surpluses does not make much economic sense. Some commentators have also argued that China's creditor status necessitates that it should take responsibility for rectifying global imbalances. We are reasonably optimistic about this, as China's increasing economic power and Beijing's growing inclination to take a leadership role in world economic affairs should force the country to be more dynamic on global issues.

These questions are closely tied to Beijing's efforts to revalue the renminbi and to allow more realistic pricing of labor (i.e., wages), energy and commodity products so as to prevent cheap Chinese goods from further flooding the world market. At the same time, rising standards of living and consumption should boost foreign purchases and compensate for potentially slower import growth that may arise from a more stable or lower investment rate.

Display 2

China Is Not an Efficient User of Capital

Incremental Capital-Output Ratios*



*A ratio to measure capital efficiency by dividing the change in output (GDP) into the change in capital stock required to produce it

For China, India and Indonesia, the ratios are the averages of the past ten years. For Hong Kong, Taiwan, Korea and Singapore, they are the averages of the 1970s and 1980s. For Japan, it is the average of the 1950s and 1960s, and the US's ratio is the average of the 1940s to 1960s.

Source: CEIC Data and AllianceBernstein estimates

The Destination Is Clear but the Road May Be Bumpy

In our view, recent evidence suggests that the message from Beijing is loud and clear: a new development model is here. And in China's autocratic capitalist system, the policy awareness of this new mission is high from top to bottom of the command chain. However, this is not to underrate the challenges the leadership faces as the country pursues its next leap forward. They will require a dedicated balance of many structural reform policies to achieve a smooth and effective transformation.

The next question is how far this restructuring process has already progressed. Crucial to answering this question will be an analysis of how much of the rebalancing we have seen so far is down merely to cyclical factors and how much represents the start of genuine structural change. We will investigate this issue in our next Asian economic commentary. ■

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