

China's Need for Consumption-Led Growth

A NEED TO REBALANCE

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Background

- Over the past few years, China's economic growth has become increasingly dependent on increases in investment and net exports. The government has recognized the need to expand domestic consumption and rebalance its economic growth, but actual progress in that direction has been very limited. The recent economic slowdown in China's major export markets reinforces the importance of moving to a more consumption-driven economy.

Current Situation

- Household consumption accounts for slightly more than a third of total output, the lowest of any country in the world. The government can promote consumption via fiscal, financial, exchange rate, and price policy.
- Fiscal policy options include cutting personal taxes, increasing government consumption expenditures, and introducing a dividend tax on state-owned companies. The most effective step would be to increase government spending on the social safety net, particularly on outlays for health, education, welfare, and pensions. Because Chinese families lack programs in these areas, the high level of household savings, running at 25 percent of disposable income since 2000, seems primarily precautionary.
- Beijing has greatly expanded selective social programs in recent years. For example, central government outlays on the rural cooperative medical system, initiated in 2002, rose to 11.4 billion renminbi (RMB) in 2007, a 20-fold increase compared with 2005, raising the number of rural residents covered by the program to more than 730 million, quadruple the number covered in 2005. Budgeted outlays for this program jumped an additional 120 percent in 2008 to reach RMB 25.3 billion.

INVESTMENT VS. CONSUMPTION IN CHINA

- As early as December 2004, the Chinese Communist Party recognized the need to adjust the relationship between investment and consumption as sources of economic growth.
 - In mid-2005, the central bank refined this theme, arguing that investment growth needed to slow further to allow demand to catch up with supply in sectors such as steel, aluminum, cement, real estate, and even electric power, where excess capacity was evident or predictable.
 - The bank also doubted the sustainability of rapid net export growth, if for no other reason than the likely rise of foreign protectionism, and concluded that China needed to transition to a more consumption-driven growth path.
 - This objective has since been reprised in a number of important government documents and by Premier Wen Jiabao in speeches to China's national legislative body in the spring of 2006, 2007, and 2008.
 - Although it may take time, a transition to more consumption-led growth would be a welcome development for the United States and the global economy.
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- China should continue to increase outlays for social programs. As families gain confidence in the government's provision of health, education, and other social services, they will voluntarily reduce their own savings and increase consumption. Although the transition to a more consumption-driven growth path started with increased government consumption expenditures, government action will be reinforced by changes in household patterns over time.

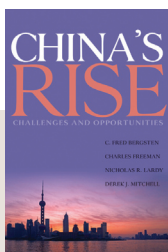
Current Situation

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- The decline in household consumption reflects not only an increase in savings but also a decline in disposable income as a share of GDP. This results partly from financial repression reflected by low and negative real interest rates. At present, most household savings are in bank deposits. But the authorities fix nominal interest on these deposits at rates well below the rate of inflation. If households in the first quarter of 2008 had received the same real rate of interest on their demand and time deposits as in 2002, their additional interest income would have equaled about 6 percent of GDP.
- To achieve rebalancing, Chinese authorities must allow the exchange rate to appreciate further. Appreciation of the renminbi will reduce the growth of exports and increase the growth of imports, reducing China's external imbalance. In addition, China's highly undervalued exchange rate limits its ability to use monetary policy. For example, China is constrained from raising domestic interest rates because higher rates would attract investors in the renminbi and thereby make it harder for China to suppress its value in relation to other currencies.
- The prices of energy, most notably oil and electricity, are still controlled by the government in China. When oil prices rise, only part of the increase is passed on to the retail consumer. Coal, the main input for generating electricity, is generally priced in the market. But price controls on electric power insulate consumers from the effect of rising coal prices. More appropriate pricing, including enforcement of existing environmental standards, would tend to reduce investment in manufacturing, particularly the most energy-intensive industries, and increase investment in services.

Implications

- Despite some positive steps taken by the government on social programs, economic growth actually has become even more unbalanced since 2004. In 2007, household and government consumption as a share of GDP declined by 5.3 percent compared with the level in 2004, while investment fell merely by 1 percent and net exports jumped by 6.4 percent.
- China's growth began to slow in the second half of 2007, in part because of slowing growth in its major export markets and in part because of softening property investment. In light of the global economic slowdown, export growth seems likely to fall further.
- Faster expansion of private consumption has the greatest potential to counter the likely slump in exports and keep China's growth from falling below 8 percent. But this will require more vigorous government policy action in all four domains—fiscal, financial, exchange rates, and pricing.
- China's growth rate dropped sharply to 6.8 percent in the fourth quarter of 2008, below the pace that the authorities believe is necessary to generate new jobs and maintain social stability. To counteract this slowdown, the government has eased monetary policy, initiated a massive increase in government investment projects, and stepped up government outlays on a variety of social programs. These policies have a reasonable chance of boosting China's yearly growth in 2008 to between 7 and 8 percent and thus increasing China's contribution to global economic health.



FOR FURTHER INFORMATION:
SEE CHAPTER 6: "SUSTAINING ECONOMIC GROWTH IN CHINA" IN
CHINA'S RISE: CHALLENGES AND OPPORTUNITIES
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