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# The Contentious Debate Over China's Economic Transition

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Much of the news coverage about the recent meeting in Beijing of the National People's Congress has focused on the government's determination to bring down inflation. An even more interesting story, however, may be the difficult internal debate on Beijing's longer-term effort to raise the level of Chinese household consumption.

This is not to say that the fight against inflation isn't an important issue. In Premier Wen Jiabao's opening speech on March 5, it was noteworthy that the top priority on his list of government objectives for the next five years was containing rising prices. This is the first time in many years that maintaining high economic growth was not listed as the top priority. The second priority Wen listed, however, was raising the household consumption share of China's GDP.

At the risk of oversimplifying a complex debate—whose political sensitivities make the debate itself at times somewhat oblique—the issue is whether or not China can rebalance its economy toward a greater reliance on domestic consumption by engineering administrative measures targeted specifically at consumption. Vice Minister of Commerce Jiang Zengwei, for example, recently announced a development plan, to be released in April, in which, according to the People's Daily, "efforts will be made to further expand domestic consumption demand, vigorously promote consumption of residents in urban and rural areas, foster new consumption growth areas, accelerate circulation modernization, develop chain operations and speed up the development of e-commerce."

But will the execution of the plan actually increase consumption? Although much of the policy-making establishment seems to believe that these measures can work, a small but growing group insists that China cannot raise the consumption share of GDP without a major adjustment in the growth strategy that has been in place for the last decade. Previous administrative attempts to boost consumption—for example, the automobile and white-goods subsidies of the past two years—have increased consumption of specifically targeted items, they point out, without boosting overall consumption.

If that's the case, the administrative measures are likely to fail because they do not address the underlying problem, which is the low share of Chinese household income. The measures will merely boost consumption of certain favored items at the expense of other items, and overall consumption will stagnate as a share of GDP.

In the end, resolving this debate may be the most important economic issue for China's policy makers. Rebalancing growth from investment to consumption will be a difficult task at best, but the process will determine the success of China's long-term economic growth.

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## The evolution of Chinese consumption

The growth and evolution of Chinese household consumption has been one of the most interesting and important economic stories of the past few decades. As the table below shows, in the 1980s—after China's reform and opening up—household consumption comprised 50–52 percent of China's GDP. This is low, but not exceptionally low by the standards of high-saving, low-consuming Asian countries.

| Year | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 |
|---|---|---|---|---|---|---|---|---|---|---|
| Consumption share of GDP | 50.8 | 52.4 | 51.9 | 52.0 | 50.8 | 51.6 | 50.5 | 49.9 | 51.1 | 50.9 |

Both household income and household consumption grew quickly over the next two decades, but not as quickly as China's economy. As a result, during the 1990s, consumption declined as a share of GDP. This decline wasn't smooth, as the table below shows. During the inflationary crisis of 1993 and 1994, for example, household consumption dropped sharply to below 44 percent of GDP, before recovering somewhat to finish the decade at 46 percent.

| Year | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 |
|---|---|---|---|---|---|---|---|---|---|---|
| Consumption share of GDP | 48.9 | 47.5 | 47.2 | 44.4 | 43.5 | 44.9 | 45.8 | 45.2 | 45.3 | 46.0 |

Although a consumption share of 46 percent of GDP is not unprecedented, it is nonetheless very low for such a large economy, and it means that the main sources of Chinese growth were going to be rising investment and a rising trade surplus. Both increased rapidly during the next decade, and between them generated astonishing growth rates of over 10 percent annually.

But around 2000, the divergence between GDP growth and consumption growth suddenly widened. As the table below shows, by 2005, household consumption had dropped to just under 39 percent of GDP, a number that until then was unprecedented in history for a large economy in times of peace. At the time, it was widely recognized that such a low consumption share meant that China was very vulnerable to changes in the ability of the rest of the world to absorb its trade surplus.

| Year | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
|---|---|---|---|---|---|---|---|---|---|---|
| Consumption share of GDP | 46.4 | 45.3 | 44.0 | 42.2 | 40.6 | 38.8 | 36.9 | 36.0 | 35.1 | 35.1 |

And these trade surpluses were becoming extraordinarily large. By 2007, China's trade surplus had become the largest as a share of global GDP ever recorded—far surpassing, for example, the trade surpluses Japan generated in the late 1980s (when its economy represented more than twice China's current share of the world economy) or the U.S. trade surplus of the late 1920s (when the United States comprised four times China's current share of global GDP).

Clearly China could not count indefinitely on rising trade surpluses to absorb the growing imbalance between what it produced and what it consumed. Under Premier Wen's leadership, the administration resolved during this time to rebalance the economy and increase the household consumption share.

But the low consumption share is not just an accidental consequence of China's cultural institutions. It is a fundamental requirement of the development model, and it cannot be reversed without China's abandoning the model. Not surprisingly, Beijing was unwilling to do that. The result was predictable. Instead of rising, household consumption declined further to an astonishing 35 percent of GDP by 2009. The numbers for 2010 will not be released until much later this year, but few analysts believe that the consumption share rose in 2010.

## Household income

Understanding the relationship between low consumption growth and high GDP growth is key to understanding both China's growth model and the domestic imbalances it generates. To put it briefly, China has been able to grow during the past decade at a breakneck pace in part because of a series of implicit taxes on household wealth, the proceeds of which are used to fuel the manufacturing and investment boom.

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Three such implicit taxes were especially important. The one most widely understood by economists is the undervalued currency, which acts as a tax on consumption and a subsidy for manufacturers in the tradable goods sector. This tax effectively boosts manufacturing, but at the cost of reducing the purchasing power of household income by raising the cost of imports.

The second implicit tax was the growing divergence between productivity growth and wage growth. Some divergence characterized most of post-reform China's economic history, and is fairly common in developing countries posting high growth rates, but the difference between the two accelerated sharply in the past decade. During this time the productivity of Chinese workers has tripled, while their wages have only doubled. The consequence is that workers receive a continuously declining share of China's total production.

The most important and still least widely recognized of these implicit taxes was a consequence of the extremely low interest rate imposed on Chinese household deposits in favor of Chinese borrowers. Artificially low interest rates transfer wealth from net savers, who are mainly households, to net users of capital, who are mainly large manufacturers, real estate developers, infrastructure investors, and various government entities. Every year during the decade, as much as 5–7 percent of GDP was transferred from household depositors to banks and borrowers in this form.

It is important to understand that although they took very different forms, each of these three implicit taxes had the same overall consequence. Households received a smaller and smaller share of the growth generated by the country. Currently household income represents 50 percent of China's GDP, one of the lowest shares ever recorded. The result of these policies was very rapid growth, but it came at the expense of increasingly misallocated investment—which had to be extremely high to make up for the declining impact of household consumption—and greater domestic imbalances.

China is not the only country in history to have used this kind of heavily subsidized, investment-driven growth strategy. In fact, nearly every economic "miracle" of the past century has been based on one version or another of this strategy, from the Soviet Union in the 1950s and 1960s and Brazil and Venezuela in the 1960s and 1970s, to Japan in the 1970s and 1980s and the Asian Tigers in the 1980s and 1990s.

In some cases, such as Brazil, explosive investment-driven growth in government-selected projects was funded and subsidized by very high income taxes. Starting from a low base, Brazil put into place a very valuable infrastructure, but it continued expanding rapidly long after the government had run out of obvious investments. It even embarked on its own version of Go West, to open up and develop the very poor non-coastal regions, a project driven more by political objectives than by economic ones, as very few businesses had much interest in the interior of the country. In other cases, as in Japan in the 1970s and 1980s, it was the hidden taxes in the form of artificially low interest rates and an undervalued currency that funded the growth.

One way or the other, however, governments were able to generate tremendous growth by artificially boosting investment and generating enormous externalities when the private sector was unwilling to do so itself. But they did so at the expense of disposable household income, whose growth, while often substantial, lagged growth in the overall economy.

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Lagging household income, however, was not a problem at first. In all of these cases, the generation of wealth was substantial and resulted in material improvements in the lives of the poor. Likewise, it has been a very successful model for China for many years.

## The end of the growth model

But ultimately, as all of the previous examples suggest, there are constraints in the ability of the growth model to generate wealth sustainably. The most important of these constraints are, first, an overreliance on the rest of the world's ability to absorb rising trade surpluses and, second, the inexorable tendency of heavily subsidized, state-directed, rapidly expanding investment toward capital misallocation. The first constraint is usually a problem only for large economies, like the United States in the 1920s, Japan in the 1980s, and China today, whose trade surpluses are large relative to the rest of the world.

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The second constraint has turned out to be a problem for everyone. Capital misallocation creates the illusion of growth by generating employment, but it can actually destroy wealth if the total economic value of the investment is less than the total economic cost. This wealth destruction, however, is only evident if the price of inputs, especially capital, are correctly valued; because of the heavy subsidies, they almost never are.

The consequences of this wealth destruction are disguised by the positive impact of investment in the short term but they inevitably show up many years later in the form of much slower growth—and higher debt, if growth has been funded by borrowing. Japan, for example, spent much of the past two decades paying for the massive hidden wealth destruction that took place in the 1980s as artificially low interest rates and an undervalued currency created the illusion of spectacular growth, just as Brazilians suffered the "Lost Decade" of the 1980s.

It is increasingly obvious that China has reached both constraints. The global financial crisis has eliminated the ability of the rest of the world to absorb China's large trade surpluses, and capital misallocation has been a serious problem for much of the decade. A number of studies have pointed out, for example, that state-owned enterprises in the aggregate have lost money over much of the past decade if all of the subsidies are accounted for. If capital misallocation is becoming a problem, clearly China must make a major transition to a different growth model—one that allows household wealth and consumption to catch up with the enormous wealth generated in the past three decades so as to become an increasingly important driver of growth.

And it is now widely accepted in policy-making circles that China must make the transition. But here's the catch. If administrative measures to boost consumption don't work, the transition will require that China significantly reduce investment growth. The more investment China piles up, the more necessary it becomes to continue and even increase transfers from the household sector to keep those investments viable. Wasted investment must be paid for, and it is the household sector, one way or another, that pays.

But if the government mandates a deceleration in investment growth, the consequence will be as dramatic as it is unwanted. Rapid increases in investment are the main tool policy makers have to maintain high growth rates in China—some would say the only tool—and any slowing down of investment growth will translate immediately into a much slower GDP growth.

This is why the debate within China has become so difficult. Reformers argue that the transition to a more sustainable growth model inevitably requires sharp reductions in credit expansion and investment and, with those constraints, a dramatic slowdown in GDP growth is inevitable. As long as China keeps expanding investment and capacity, they point out, the downward pressures on household income will rise, and it will be increasingly difficult to raise the consumption share of GDP. What's worse, debt levels will continue to grow and eventually may become unmanageable.

## The cost of rebalancing

Their opponents, who are far more numerous, generally do not see the link between rapid growth and unbalanced growth. Many of them are from sectors that have benefitted enormously from the household wealth transfers—most obviously the export sector, state-owned enterprises, and local and municipal governments—and, not surprisingly, they are resistant to the idea of reducing or reversing these transfers. They argue instead that China can take administrative steps to improve consumption levels without needing to decelerate investment.

But the numbers don't support the optimists. Unless Beijing employs alternative methods of increasing household wealth and income sharply—for example, directly or indirectly transferring ownership of state-owned enterprises to the household sector—there is simply no way China can generate sharp increases in household consumption while keeping investment levels high unless investment in the aggregate can generate more than sufficient economic value in the next few years to justify the costs. Because much of the investment will only generate sufficient value over many, many years—and some of it never will—the growth in investment will itself put downward pressure on household income as the central bank is forced to keep interest rates low.

How quickly China resolves this debate is crucially important. The historical precedents make it clear that once domestic imbalances are severe, the longer a country waits to shift away from an investment-driven growth model, the more painful that shift will be. The problem with postponing the adjustment is that debt levels rise inexorably and—as we are about to be reminded yet again by peripheral Europe—high debt levels themselves act as a constraint on growth.

But historical precedent also makes it clear how powerfully addictive that model is. It is hard to find a single example of a country adjusting smoothly and quickly from a period of excessive investment-driven growth—just look at the United States in the 1930s, Brazil and Venezuela in the 1980s, the Soviet Union in the 1970s and 1980s, Japan in the 1990s, and the Asian Tigers after 1997. In every single case excessive debt led to a sharp growth contraction and a "lost" decade or two.

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This is the challenge for China's new leadership. They take power in late 2012 and, until then, we can probably expect at least another year of rapid, investment-driven growth. But, say the reformers, we can also expect that as long as investment continues surging, the household consumption share of GDP will stagnate, or even decline further. It is not until China makes the transition, planned or unplanned, to a new growth model—one that is labor-intensive, consumer-oriented, and driven by rapid expansion in the services sector—that the painful process of rebalancing will begin.

Obviously it is better to plan the transition than to have circumstances—which usually come in the form of rapidly rising debt—force the transition upon the economy. In Beijing, the difficult debate between the reformers, who are as unpopular as anyone who brings bad news is likely to be, and those who see no reason to abandon a model that has generated such spectacular growth, has become one of the most significant debates in the world. How quickly it is resolved will determine the pace and nature of China's economic growth over the next several decades.

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