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Report

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➤ China's Strategy towards the Financial Crisis and Economic Reform

Linda Yueh

China's pragmatic attitude towards its own 30 years of reform can be used to similarly characterise its attitude toward the global financial crisis of 2008 and the resultant push for further economic reforms. China was able to manage the downturn following 2008, and has a good chance of managing the consequences of Europe's slowdown by undertaking fiscal and monetary stimulus. The debate over global imbalances has increased the need for nations to re-balance their economies, including China. The Chinese economy requires re-balancing to sustain strong growth rates in the coming decades, with the slowdown in the West making the re-orientation towards growth by domestic demand an even greater imperative.

RE-BALANCING THE ECONOMY

The 20 million workers who lost their jobs in the export sector and the damage to Chinese GDP during the 2008 global financial crisis have increased the impetus behind the already planned re-balancing of the Chinese economy. The 12th Five Year Plan is focused on transforming the economy into a more sustainable model, so that the country can grow well for another 30 years.

The structure of the Chinese economy can evolve to become more akin to the United States and Japan, which are both large economies whose growth is primarily driven by domestic demand, but which are at the same time among the largest (third and fourth, respectively) traders in the world. In 1990, China was closer to the structure of the economies of the United States and Japan in that exports accounted for 12.9 percent of GDP in China and around seven percent in the United States and Japan. Since then, the success of the 'open door' policy has seen China's economic balance come to resemble that of Germany. Exports in 2007 accounted for 56 percent of Chinese GDP and for 76 percent of German GDP (though it should be noted that intra-European trade in the single market accounted for around three-quarters of German trade). In 2009, when global trade contracted for the first time since World War II – by 12.2 percent according to the WTO – both Germany and Japan experienced recessions that were deeper than in the United States, the epicentre of the financial crisis. In China's case, despite large-scale redundancies in export industries, a technical recession was avoided through swift implementation of fiscal and monetary stimulus that succeeded in significantly increasing domestic demand.

China could reduce its exposure to the volatility of the world economy by following a path to strengthen both internal and external demand, which would increase the portion of growth driven by domestic demand even as trade expands in absolute terms. Such restructuring will allow China to continue to benefit from global integration, which includes learning from the technological advancements of developed economies, and to continue its 'catch up' growth, while maintaining a larger base of domestic demand to shield it from the worst excesses of external shocks.

Reorienting towards domestic demand means boosting consumption in China, that is, reducing households' and firms' tendency to save. Consumption fell from around 50 percent of GDP in the 1980s and early 1990s to just under one-third by the late 2000s. In developed economies, consumption is typically between half and two-thirds of GDP, for example, in Germany it is 58 percent, Japan registers 60 percent and it was 72 percent in the United States on the eve of the 2008 global financial crisis (the latter was generally considered to be too high).

For Chinese households, precautionary savings motives are important to address, particularly in rural areas, so China needs to make substantial investment in social security provision. There were some measures in the government's stimulus plan of 2009, which increased health and pension spending, but more is needed. Developing the service sector will also boost domestic demand by increasing the non-tradable component of the economy, and by creating jobs in both the low and high-ends of the skills spectrum. Furthermore, increasing urbanisation can improve the earning potential of rural residents and boost consumption. Indeed, wage bills that have lagged behind output growth reduced workers' share of national income, which in turn depressed consumption and caused it to shrink as a share of GDP.

There has also been an increase in savings by firms (both state-owned and non-state-owned) during the 2000s. China's distorted financial system is biased toward state-owned enterprises (SOEs), and private firms have trouble obtaining credit – either from banks or China's underdeveloped domestic capital markets. Therefore, private firms rely heavily on retained earnings to finance their growth. SOEs, on the other hand, save because of the minimal taxation of their profits. These distorted incentives towards saving for firms meant that when China's current account surplus was near 10 percent of GDP after 2004, China's investment maintained its share of GDP, even though investment is typically squeezed when countries develop a current account surplus. Consumption dropped as the motives for saving were undiminished by the export boom, and total savings rose instead.

DOMESTIC REFORMS

The policy reforms needed to increase aggregate demand in this framework centre on reducing the savings rate of households and firms to generate higher output in the context of a smaller trade surplus. Greater government spending can also increase consumption and investment if undertaken to support private incomes and the efficiency of capital markets.

Household savings have averaged 19 percent of GDP since 1992, following the significant opening of the Chinese economy, and the associated decline in domestic consumption's share of GDP. Savings were already high, but they increased by a further eight percentage points after 2000, rising to 22 percent of GDP by 2007 at the onset of the global financial crisis. For firms, the average savings rate was lower – at around 15 percent of GDP between 1992 and 2007 – but this grew quickly to reach 22 percent of GDP by the mid-2000s. The remainder of Chinese savings derives from government, whose savings rate doubled from 5.2 percent in 2000 to 10.8 percent in 2007. Taken together, China's savings rate increased from 38 percent of GDP in the 1990s to a peak of nearly 52 percent by the late 2000s. Startlingly, the savings rate increased by 17 percentage points during the first decade of the 21st century, mirroring the fall in consumption as a share of GDP from around 50 percent of GDP in the early 1990s to 35 percent by the late 2000s.

Therefore, for households, addressing the savings issue centres on lagging wage and income growth; while for firms, reforming capital markets is critical. For households, income growth and removing the motives for precautionary savings would bring down the savings rate. Industrial output has grown at 14.1 percent on average per annum for 20 years since 1988, but wage growth has not kept pace. Industrial output grew at double the previous pace in the 2000s, averaging 23.1 percent per annum. Yet, the average annual real wage growth of urban employees was lower, at 11.9 percent over the period between 1995 and 2008, and a paltry five percent during the late 1990s. Rural incomes have risen even more slowly.

In the 2000s, average wage growth was faster at 14.9 percent per annum, but against a backdrop of industrial output growth exceeding 23 percent each year. Thus, because labour income has lagged behind output growth, consumption has fallen as a share of GDP.

Moreover, labour productivity has increased seven-fold from 1980 to 2005, according to the International Labour Organisation (ILO), which suggests that wages do not match the marginal product of labour. Labour productivity has been improving in the 2000s since the significant reform of labour markets at the end of the 1990s, and the improvement has been hastened by recent supply-side tightening. The protests in 2009/10 over low wages, and a reluctance of rural migrants to return or move to the cities, reflects the potential for increased wage growth to match the marginal output of labour. In so doing, there need not be inflationary pressures so long as higher wages prompt growth in labour productivity that matches any future wage increases and instead can increase incomes and boost consumption.

Other measures that can ease labour market tightness involve removing restrictions on mobility, that is, increasing urbanisation by allowing migrants to settle in urban areas. It would reduce segmentation in the labour market and increase the mobility of workers to find matches to appropriate jobs and not be barred by geographic or *hukou* (household registration system) barriers. Urbanisation is a policy that has been proposed alongside renewed efforts to develop the services sector. The services sector increased steadily as a share of GDP from 23 percent in 1979 to 40 percent in the 2000s but has not developed further. China has a lower share of services in GDP than comparably-sized economies where the services sector accounts for more than half of GDP (for example, in the United Kingdom it is over 80 percent). Services is a non-tradable sector as it includes items such as hair cuts and government services, and would help to increase both domestic demand and reduce savings if such service provision included the delivery of social security. Thus government spending on services can significantly reduce the savings rate of the economy while boosting domestic demand and incomes. Urbanisation further allows the delivery of services

to be distributed more efficiently such that there can be greater economies of scale. For instance, health, pensions, unemployment, local services, and schools can all be developed as part of the services sector along with the infrastructure needed to support this development, which in turn increases the efficiency of investment and associated industrialisation in the urban area.

Together, internal and external sector reforms would improve the efficiency of the urbanisation process by reducing the cost of imported inputs. It would further help on the income side for households since a stronger renminbi would reduce the cost of imports, particularly food, and increase disposable income. Removing the 'ceiling' on deposit rates would also increase interest income to households, which has plunged into negative territory, with inflation exceeding the deposit rate in the late 2000s. The combination of internal and external re-balancing would thus assist with reducing household savings and increase output.

FINANCIAL REFORMS

Further liberalisation of interest rates would improve credit allocation to non-state sector firms and reduce the savings incentive for firms too. Although interest rates were partially liberalised, including in 2004 when the ceiling on inter-bank lending rates was lifted, there are still limits in terms of the 'floor' on the lending rate. Interest rates reflect the internal rate of return to investment, so such controls distort lending decisions. These restrictions preserve bank margins in the same way that capital controls preserve the deposit base, but they lead to high rates of corporate saving.

Such reforms should render the allocation of capital more efficient even though the rate of investment may not increase, suggesting greater output for the same amount of invested funds. Returns on assets are high in China, but they are greater for all types of private firms than for SOEs and collectives. Yet SOEs continue to receive disproportionate amounts of credit despite being less productive. Without interest rate liberalisation and further reforms of the financial system, the extent of financial repression distorts credit allocation and induces saving by private firms,

which contributed as much as that by households to the increase in the savings rate in the 2000s. Wages below the marginal product of labour generate profits, but capital market reform will reduce the distortions to firm savings behaviour, particularly if it is linked to capital account reform.

CHINA'S OUTWARD INVESTMENT

Gradual capital account liberalisation, in particular the 'going out' policy that is encouraging Chinese firms to operate as multinational corporations, can reduce savings if firms are permitted to operate in global markets and are allowed to access funding from better-developed overseas credit markets. In other words, firms can raise money on capital markets and not just rely on China's banking system with its controls on credit.

More generally, state-owned enterprises and increasingly private firms have been encouraged by the Chinese government to 'go out' and compete on global markets. Launched in 2000, 'going out' is intended to create Chinese multinational corporations that are internationally competitive. By doing so, China aims to become more than a generic producer of low-end manufacturing goods, branded under the moniker of Western firms. Its firms' ability to be as innovative and productive as leading global companies is an indicator of industrial upgrading, the very thing that China needs to ensure a sustained growth rate.

For instance, Haier is the largest white goods maker in China, and although it is sold in Walmart it does not command brand recognition and loyalty in world markets. The strategy of Lenovo, therefore, was to not only purchase IBM's PC business but also to license the use of the brand name for five years so that Lenovo can eventually assume the trusted name of IBM in world markets. These are all developments which took place starting in the mid-2000s, when the first commercial outward investment by a Chinese company was permitted in 2004 with the purchase of France's Thomson by electronics firm TCL.

Most outward Foreign Direct Investment (FDI) remains state-led investments in energy and commodities, but the maturing of Chinese industry indicates that the trend is changing as China seeks to move up the value chain and develop multinational companies that can follow in the footsteps of other successful countries like Japan and South Korea. These countries, unlike most developing countries, managed to join the ranks of the rich economies through possessing innovative and technologically advanced firms that enabled them to move beyond what is sometimes termed the 'middle income country trap', where nations' growth slows as they reach a per capita income level of \$14,000. The process of growth through adding labour or capital (factor accumulation) slows or reaches its limit, and they are unable to sustain the double digit growth rates experienced at an earlier period of development. By increasing productivity instead through developing industrial capacity and upgrading that is stimulated by international competition, it is more likely that a country can maintain a strong growth rate. The need for energy as well as upgrading industrial capability is the motivating forces for China to invest overseas. Nevertheless, by the end of the 2000s, the share of commercial outward investment remains small whilst state-owned firms continue to constitute the bulk of outgoing FDI. The shape of things to come, though, points to China becoming a net capital exporter: the process of its firms 'going global' could herald an era of Chinese multinational corporations.

There has been explosive growth of outward FDI since the mid-2000s, due not only to SOE investment in commodity sectors but also to commercial mergers and acquisitions of private companies like Lenovo, which purchased the IBM PC business for the then-record of \$1.75 billion in 2005, later surpassed by Geely's acquisition of Volvo for \$1.8 billion in 2010. Becoming a net capital exporter is also viewed as a marker of a country reaching a level of industrial development where its firms are able to operate and compete on world markets. With outward FDI accelerating and close to overtaking inward FDI by the end of the 2000s, China could be on track to demonstrate that its industrial capacity is not only a function of foreign invested enterprises producing its exports,

but indicative of a more widespread upgrading of its industry. The policy aim of 'going out' or 'going global' looks to be being realised at the end of the first 30 years of reform.

There are also a number of macroeconomic benefits. Capital account reform would not only reduce the motive for corporate savings but also cut the portion of the current account surplus that is funded through the purchase of US Treasuries by allowing capital outflows in the form of investments instead of accumulated in foreign exchange reserves. The exchange rate should also become more flexible with greater capital account liberalisation since the capital account and the current account will require the renminbi for transactions. Recent measures to increase the use of the renminbi in trade arrangements already point to the growing internationalisation of the Chinese currency. Therefore, exchange rate and interest rate reforms together should produce a better balance between China's internal (savings and investment) and external (balance of payments) positions and help to re-balance the economy.

CONCLUSION

China can be a fast growing, large, open economy – developing domestic demand and upgrading industry and promoting globally competitive firms – that recognises its wider impact because it is unlike small, open, export-led economies which do not affect the global terms of trade. Given China's still low level of development, global integration would benefit its own development as well as that of the world. These macroeconomic reforms will be important to position China optimally in a global economy that is significantly different and more uncertain than before. By doing so, China could grow well in the years to come. It may have done something extraordinary in growing strongly for 30 years, but at per capita income levels of just \$4,200, there is still considerable scope for 'catch up' growth and thus the importance of not only attracting investment via the 'open door' policy, but also the increasing emphasis on 'going out.' By so doing, its global investments and corporations will affect the contours of the corporate sector internationally.

Global imbalances have existed for some decades and their exacerbation in the 2000s formed the backdrop to the worst financial crisis in a century. In the short-term, the world has already somewhat re-balanced with the US current account deficit falling from six percent to around three percent of GDP in 2010, and savings rising in recessionary countries. This further implies that China and other countries will need to re-balance their economies to sustain the rate of growth of the 2000s, which was driven by strong US imports and demand.

For surplus countries like China, loose American monetary policy can be transmitted via fixed exchange rates, which leads capital to flow from low to high interest rate economies. Thus, China should gradually reform its exchange rate to prevent domestic asset bubbles such as those that have occurred in the non-tradable real estate sector. Increasing the flexibility of the renminbi exchange rate before tightening monetary policy will also be important as an increase in the interest rate in China – while the United States Federal Reserve is committed to maintaining a near-zero interest rate – will only worsen the capital inflow, eroding the impact of tightening measures.

Therefore, reforming the exchange rate and the interest rate can induce higher output growth if the switch to higher consumption can be managed while the trade surplus is smaller. The continuation of global imbalances further implies that such liberalisation must be carefully regulated to prevent destabilising capital flows as global liquidity will remain an issue. Re-balancing China will not correct global imbalances, but the acute management of the trade surplus along with a recognition that such action will have some effect on re-balancing the global economy will mean a more sustainable growth path for China and perhaps the world economy. In other words, China's policies towards re-balancing are promising steps to transform its economy into a stable and prosperous society with positive benefits for the rest of the world. However, it will need to decide that it will aim to become a large, open economy and decisively move away from excessive reliance on export-led growth, which is more feasible in any case at this stage of development. China's decision on that front will shape its destiny in the coming decades. ■