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Is China rebalancing? Yes, but with Chinese characteristics

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Theme

The Chinese economy is gradually rebalancing, but for the foreseeable future investments (and not private consumption) will continue to be the main drivers of growth.

Summary

The aim of this paper is to summarise and analyse the key reform policies undertaken since Xi Jinping took power. It will be argued that China is rebalancing, but on its own terms and at its own pace. Rather than striving quickly for a consumption- and services-led economy, the Chinese leadership is more interested in reforming and consolidating the economic, political and social structures that make such a growth model sustainable in the long term. In the short term the current model will be maintained; thus, those in the West who had high hopes that the market would play a 'decisive role' in China will remain disappointed. Most of the reforms will be inward-looking and gradual, and the Chinese Communist Party (CCP) will retain a tight control over the main levers of the Chinese economy.

Analysis

The need for reform

In 2007 China's then Premier Wen Jiabao recognised what was common wisdom among international economists, that China's economic growth model had become 'unstable, unbalanced, uncoordinated, and unsustainable'.[1] Many in the West thought this recognition would lead to a major reform plan over the next five years (especially after witnessing some minor reform efforts) but their hopes were dashed. In 2008 came the collapse of Lehman Brothers and the Great Recession, and Wen Jiabao, and his President Hu Jintao, decided not to change the course of China's development model in the midst of the deepest global financial crisis since the 1930s. On the contrary, they embraced with zeal the old levers of growth: they re-pegged the RMB to the dollar to maintain Chinese export competitiveness, implemented a huge fiscal stimulus plan (RMB4 trillion, nearly US$600 billion) and commanded the state-owned banks to free up their credit taps (bank loans surged to

1 S. Roach (2007), 'Unstable, Unbalanced, Uncoordinated, and Unsustainable', *Global Economic Forum Note*, Morgan Stanley, 19/III/2007.

RMB9.5 trillion in 2009 and RMB8 trillion in 2010) to continue China's export and investment-led growth model.[2]

With these bold actions Wen Jiabao and Hu Jintao averted disaster (a desperate adrenalin shock was needed because the patient was about to die), but they left their successors, President Xi Jinping and Premier Li Keqiang, with the task of dealing with the side-effects of this potent medicine. When they took power in early 2013 they encountered an economy threatened by a number of ills: overreliance on exports and investment, overcapacity in several capital-intensive sectors, environmental degradation, relatively low household consumption, a real estate boom, increased inequality, a worrying rise in public local-government and corporate debts, and an emerging shadow banking system. To tackle these structural problems, in November 2013 at the Third Plenum of the 18th Central Committee meeting of the CCP, the new leadership, led by Xi Jinping (the most powerful Chinese leader since Deng Xiaoping), approved an ambitious reform plan, seen as the roadmap for the next development stage in China's continuous reform and opening-up process. Critically, this plan established the year 2020 as the temporal horizon to complete the new reform phase.

The reform recipes from the West

In the eyes of many Western observers, China's rebalancing is measured by its capacity to move from an export and investment-led growth model to one based on consumption-led growth. The ultimate yardstick is to see China eliminate its domestic financial repression –the policy of having capital controls, keeping real deposit rates negative, and thus being able to finance State-owned enterprises (SOEs) at very low rates, which de facto is a transfer of wealth from households to SOEs– so that the Chinese consumer can be the driving force of the economy. Hence, these are the reforms that the Chinese leadership should undertake: (1) it should start by lifting the government-imposed deposit-rate ceiling; (2) liberalise the financial sector for a more effective and efficient allocation of capital; (3) let the RMB float so that it can appreciate, which would mean more imports and fewer exports, precisely what is needed to rebalance; and (4) open the capital account so that foreign capital can bring more competition to the financial sector and, in turn, Chinese investors (and potential consumers) can seek higher returns for their savings abroad.

To some extent, the Chinese leadership has followed this Western-designed pathway towards rebalancing. Previously there was a ceiling on deposit rates and a floor on loan rates to secure constant profitable margins for the state-owned banks. The floor has now been eliminated. More importantly, almost half of China's credit provision is now intermediated through the so-called shadow banking system where deposit and loan rates are set freely by market actors. Since 2010 the peg to the

2 S. Breslin (2014), 'Financial Transitions in the PRC: banking on the state?', *Third World Quarterly*, vol. 35, nr 6, p. 996-1013.

dollar has also been gradually loosened. The daily floating band has been widened to 2%. From 2010 until 2014 the RMB appreciated from RMB6.80 to RMB6 to the dollar, a more than 10% rise. Lastly, the capital account has also been progressively opened. The Qualified Foreign (and Domestic) Institutional Investor schemes (known as QFII and QDII) and the recently created Renminbi Qualified Domestic (and Foreign) Institutional Investor (RQDII and RQFII) programmes have increased the number of investors and the amount of money that can enter and exit China. There is also great excitement in the international markets about the newly launched Shanghai-Hong Kong Stock Connect, yet another step towards Beijing's ambition to make Shanghai a global financial hub able to compete with New York and London by 2020.

China's real economy has also experienced gradual changes. The often criticised huge current account surplus has shrunk from 10% in 2008 to 2.5% in 2013. The neck-breaking growth rate has slowed down from over 10% of GDP in 2010 to 7.5% in 2014. This reduction in growth has been partly engineered by the government by carefully piercing the real estate bubble, by restricting credit provision and by reducing industrial production. The influence of the Chinese government in steering the slowdown was recognised in September 2013 by Xi Jinping when he declared that China would 'bring down the growth rate to a certain extent in order to solve the fundamental problems' hindering the country's long-term development.[3] This statement came just a few weeks before the Third Plenum, which shows both that the Chinese government is well aware of the economy's structural problems and that it controls the main macroeconomic levers to rebalance at its own pace.

This also means that whenever the government considers that the growth rate is too weak it increases gross capital formation (investment), which remains extraordinarily high at around 50% of GDP (and consequently is gradually yielding diminishing returns). Household consumption, on the other hand, continues to be relatively weak at only 35% of GDP. This compares with investment levels at 20% and household consumption at 70% in the US, and 18% and 63% in Brazil.[4] However, it needs to be highlighted here that the accuracy of investment and household consumption data in China is an intensely debated topic. Yukon Huang, for instance, argues that 'the personal consumption-to-GDP ratio might be closer to 45% rather than the reported 35% and the investment ratio about 38% instead of 48%. If so, then China's consumption and investment ratios are in line with its Asian peers such as Japan, South Korea and Taiwan during their comparable stage of development'.[5]

3 *Bloomberg News* (2013), 'Xi says China chose slowdown to allow economic adjustment', 4/IX/2014.

4 International data in this section are taken from the World Bank database.

5 Yukon Huang (2014), 'China's misleading economic indicators', *Financial Times*, 29/VIII/2014.

The truth is that in 2013 for the first time China's tertiary service sector (46%) surpassed the secondary industrial sector (44%) as a percentage of GDP. This is a significant shift. Nonetheless, the service sector remains underdeveloped in China. In the US it accounts for 80% of GDP, and in Brazil 69%. Even in India, a comparatively poorer country, it takes 57% of GDP. However, it is important to understand which development model China wants to follow. With a GDP per capita at around US$7,000 (slightly lower than Bulgaria) and only 52% of the population living in urban areas (in the US the share is 80% and in Bulgaria over 70%), there are many Chinese economists who believe that China needs to continue to rely on gross capital formation in order to continue to develop upon a solid industrial and technological pillar. From this point of view, it would be a mistake to divert the national savings too swiftly towards private consumption. Thus, China needs to continue to invest, but it needs to invest better. It has to move away from highly polluting capital intensive sectors to greener, high-tech, service-related and labour intensive businesses. Thus, from a Chinese perspective the concept of rebalancing cannot be narrowly conceived as a switch from export and investment to consumption-led growth. In order to achieve this transformation successfully, not only economic but also broader social and political reforms will be needed.

Reform of the fiscal and tax system

One of the most important areas to be reformed, which is generally overlooked in the discussions around China's rebalancing, is the fiscal dynamic between the central and local governments. This key relationship has historically determined the stability of China.[6] Beijing has always walked a fine line between centrally and tightly-controlled tax collection and decentralised and looser (and therefore more inflation-prone) management of fiscal revenues. From 1984 to 1993 –a period of severe inflation caused by overheated local economies driving on China's opening-up in the early 1980s– the ratio of central to total government revenue declined from 40% to 22%. This dynamic of increased fiscal decentralisation was truncated in 1993-94 by the last big reformer in China, Premier Zhu Rongji, when he used the aftermath of the post-Tiananmen upheaval to recentralise revenues and restore the ratio of central government revenues to 56% of the total.

However, Zhu Rongji's reforms, while necessary at the time, created perverse incentives. With China's growth and development, local governments were first obliged to offer increased public services, while years later their taxing capacity was suddenly curtailed. This mismatch obliged them to find other sources of income such as selling land to developers and establishing local government financing vehicles (LGFVs), which since the 2010 tightening of credit are increasingly dependent on the shadow banking system to obtain new loans. To halt this dangerous debt-spiral (as of June 2013 local government debt stood at US$3 trillion),[7] which fosters the rapacious confiscation of farmers' land by local officials,

6 V. Shih (2008), *Factions and Finance in China: Elite Conflict and Inflation*, Cambridge University Press.
7 J. Lu & P. Sweeney (2014), 'China aims for more clarity on local government debt with new rules', *Reuters*, 28/X/2014.

the new leadership has announced that it will reform the fiscal dynamic between the central and the local governments.

A number of measures have been announced. First of all, Beijing has given the green light to 10 local governments to again issue local government bonds, a practice that was banned by Zhu Ronji in 1994. It has also stated that it will grant local governments the possibility of increasing their tax revenues through new property taxes and a higher share of the consumption tax, especially on polluting businesses and luxury goods. The central government has also announced that it will rebalance responsibilities and shoulder a higher share of government spending associated with nationwide public services and market regulations. But, in order to do so, it has also declared that it will introduce more transparent budgeting, more efficient fiscal decisions and a better enforcement of fiscal discipline. It is in this context of enhanced fiscal transparency that the vigorous anti-corruption campaign of Xi Jingping needs to be framed. And to some extent, this is also valid for the recent efforts to uphold the rule of law in China.

It is too early to assess whether these far-reaching reform attempts will be successful. If they are, they would signify a huge step in China's quest to establish a modern and effective state system. However, what is clear is that there are many obstacles ahead. This is not surprising. 'Tax and center-local reforms are the thorniest and most fundamental elements of a true overhaul of China's economic system'[8] and therefore resistance by powerful vested interests is proportionally fierce. Until very recently local officials had considerable room to exploit their privileged position to impose arbitrary taxes and regulations. The anti-corruption campaign is threatening to wipe away this source of income, and consequently it might undermine the party cadres' support for Xi Jinping.

The anti-corruption crusade against both local (the 'flies') and high-ranked central government officials (the 'tigers') has led the two former Presidents of China, Hu Jintao and Jiang Zemin, to warn Xi about the effects of the clean-up campaign. This could be interpreted as a clear sign that Xi's reform efforts are being effective, although some consider that this is more a campaign to eliminate rivals rather than a genuine attempt to introduce more transparency. Thus far it is too early to provide a full assessment of the reforms. Nonetheless, two aspects must be highlighted: one is that China's state system is changing; and the other is that no matter the pace of change the strengthening of administrative transparency and the rule of law will continue to be enforced by the CCP and not by independent agencies or judges. The system can be improved, but the modern mandarins of the CCP will remain in charge of building what in the Third Plenum resolution is described as 'a Socialist rule of law country', which means that China will not have a rule *of* law, but rather a rule *by* law.

8 D.H. Rosen & B. Bao (2014), 'China's Fiscal and Tax Reforms: A Critical Move on the Chessboard', *Rhodium Group Note*, 11/VII/2014.

More market and less state in the economy

Finding the right balance between the market and the state has become a big topic in China. This is acknowledged in the Third Plenum document which states that one of the core issues of China's reforms must be 'dealing with the relationship between the government and the market well'. The new leadership considers that the market should have a 'decisive role' in the 'allocation of resources' in order to 'realize productivity maximization and efficiency optimization'. However, it is also convinced that to 'comprehensively deepen reform', China 'must hold high the magnificent banner of Socialism with Chinese characteristics'. In other words, a further marketisation of the economy will be developed the traditional Chinese way based on gradual experimentation, and under the overall framework of consolidating the development of a Socialist market economy (note: not a social market economy).

The trial and error tactic of 'mixed ownership' has already started with a pilot programme centred on a few large state-owned enterprises. The State-owned Assets Supervision and Administration Commission (SASAC), which is the central agency that determines the corporate strategy of key SOEs in China, has declared that it wants to attract private investment to these companies. To accomplish this it is keen to reduce political interference in the management of the SOEs by focusing more on maximising shareholder value rather than achieving the government's goals, and by letting the SOEs' boards of directors, rather than the SASAC itself, appoint senior management and set performance objectives.

However, the marketisation process will be very slow. So far it is still unclear how much private investment will be allowed into the SOEs. Several companies in key sectors such as the State Development & Investment Corp (which builds infrastructure projects) and the China National Cereals, Oils and Foodstuffs Corp (COFCO) are under a specific pilot programme that aims to increase efficiency *but* without any degree of privatisation. Overall, in key sectors where there will be any privatisation at all it is very likely to be limited to a stake of up to 20%. The Chinese authorities are eager to attract private and foreign capital because they are aware that the average return on assets for SOEs is at around 4.6%, compared with 9.1% in private companies, but the management control of these strategic companies will remain in public hands.

It is certainly possible that on paper China will soon have a completely marketised pricing mechanism of resources in key sectors such as water, oil, natural gas, power, transport and telecommunications, as envisioned in the Third Plenum, but liberalising the pricing system does not necessarily imply the creation of a competitive free market. The party's ubiquity is set to remain. This is especially the case in the financial sector, which ultimately is the lifeblood of the Chinese economy and hence the determinant in the conduct of its development strategy.

China's development model is based on a number of institutional complementarities that hold the edifice together. If one of the parts is taken away, the whole structure starts to be fragile. The fact is that financial repression acts as an umbilical cord between the Chinese saver, who endures negative interest rates, the state-owned banks which channel these savings with a profit, the state-owned enterprises which have access to cheap credit and hire the clientelistic and nepotistic entourage of the CCP, and the Government which makes sure that the savings are used to continue investing in the nation's long-term development and prosperity, which is made up of many savers.[9] Unfortunately, this strategy creates its own perverse incentives. Apart from the corruption and overcapacity mentioned above, it encourages sophisticated savers to put their money either in real estate or in the shadow banking system, which offers higher returns. However, this speculative dynamic, spurred by the massive credit provision since the global financial crisis, has accelerated the country's indebtedness (especially of companies and local governments) from 147% of GDP in 2008 to 251% in 2014. This is still lower than the US's 260% and the UK's 277%, but these two countries have more developed financial systems than China.[10]

The lack of sophistication in credit provision is one of the reasons why the Chinese authorities have turned a blind eye to the shadow banking system. This could be seen as another Chinese experiment in dual-track pricing like the one used in the agriculture sector in the 1980s. This time it is applied to the pricing of credit risk. On the one hand, it is very likely that the floor on deposit interest rates will be maintained because it is a stable source of income for the state-owned banks, which have a lot of non-performing loans in their balance-sheets. On the other hand, in the shadow banking system the allocation of credit is less government controlled. However, this does not mean that the government does not monitor this market. Since the CCP is ubiquitous in China, it is likely that party officials are watching closely the credit provision offered, from the loan sharks in rural towns to the complex off-balance sheet credit vehicles of the big state-owned banks.

This dynamic creates a vicious circle. There is a pervasive moral hazard in China because investors know that the state is behind most of the local government and corporate debtors. The state, for its part, by controlling the credit circuit and the other key levers of the economy, knows that it has the capacity, as it did in the early 2000s, to restructure the debt overhang in a politically and socially less-disruptive way than in Western liberal economies. Of course, the CCP is also aware that this capacity would weaken if more private and foreign capital would enter the mainstream credit circuit of the economy. As for now, China remains a strong net external creditor (despite recent increases in external indebtedness). More importantly, 92% of the formal banking system is controlled by the state, and only 2% is in foreign hands.[11]

9 S. Breslin (2014), *op. cit.*
10 J. Anderlini (2014), 'China debt tops 250% of national income', *Financial Times*, 21/VII/2014.
11 A. Hersh (2014), 'China's Path to Financial Reform: Looking Beyond the Market', Centre for American Progress, Washington DC.

The challenge of urbanisation

The most likely future scenario therefore is that China will continue to rebalance on its own terms and at its own pace. Consumption will gradually rise, but exports and investments will remain the main drivers of growth. There will be a few bumps along the way (a banking crisis, and consequent debt restructuring is likely), but the trajectory will be maintained. Where will future investment go? Beijing has a few priorities. Upgrading China's manufacturing, industrial and technological capacity is one. Chinese companies are already gaining considerable market share in household durables, laptops and mobile phones and cargo and tanker ships, and in the coming decade they will be fierce competitors in key high-value-added goods such as pharmaceuticals, cars and aircraft, sectors that today are still dominated by Western and Japanese companies. Beijing will also invest in developing the Western part of the country, which is still very poor. The proposed Silk Road, which aims to connect China with Europe (and the countries in-between) via both sea and land, falls into this overall objective. To finance this ambitious project, China has already set up the Asian Infrastructure and Investment Bank (AIIB), whose headquarters are in Beijing.

In parallel, China's new investment will fund the urbanisation plan which was released by the State Council in March 2014 after three years of deliberations. According to the plan, China's leadership aims to transfer over the next few years 100 million of its citizens from rural to urban areas, thus increasing the country's total urban population from the current 52% to 60% by 2020. This will require an extraordinary investment effort. The plan envisions the construction of around 30 million new housing units over the next seven years and it has already put aside US$162 billion to redevelop urban shantytowns. The Chinese leadership has also guaranteed better access to schools and hospitals and it has already designed concrete infrastructure and transport connections for all these new urbanites. By 2020 all cities with more than 200,000 residents will have a rail station and those with more than 500,000 a high-speed rail connection. Ninety per cent of the urban Chinese population will have an airport close by. The question is whether all this can be achieved without seriously damaging the environment.[12]

In order to undertake this transition in an orderly manner (and not overcrowd the bigger cities), the State Council has decided to gradually reform the *hukou* household registration system. More concrete guidelines have been established to acquire urban *hukous*. Farmers have now almost no restrictions if they want to move to townships and small cities, needing to fulfil certain requirements such as being formally employed for a number of years if they want to apply for an urban *hukou* in cities with between 3 to 5 million people, and they know that it is very difficult to obtain a *hukou* from the big cities with more than 5 million inhabitants because they apply a tough points system that rewards mostly high skilled and wealthy

12 J. Maher & Xie Pengfei (2014), 'China's New Urbanization Plan: Obstacles and Environmental Impacts', *The Nature of Cities*, 11/V/2014.

individuals. It remains to be seen whether this gradual and more environmentally-friendly transition from rural areas to smaller cities works. The reality is that many farmers still want to go to the larger cities, where there is more employment, knowing only too well that this condemns them and their children to live without an urban *hukou*, and consequently without the right to access public services such as schooling, healthcare and pensions. Nonetheless, the government is aware of this. Its stated goal is to offer urban *hukous* to only 45% of the urban population by 2020. Unfortunately, the remaining 55% will have to continue to cover these basic services with their own savings since many local governments are not in a financial position to cover them.[13]

This brings the present analysis full circle. The Chinese leadership knows perfectly well that it stands before huge social and environmental challenges. If it wants to reallocate millions of Chinese farmers to smart and green cities, and provide them with a basic welfare network that assures their well-being and consumption capacity, it will have to gradually increase the country's birth rate in order to build a more stable demographic pyramid and it will need to develop a well-designed tax system which distributes efficiently tax revenues and public service expenditure between Beijing and the local governments. Ultimately, China's successful rebalancing hinges on this task.

Conclusions

Like many other big economies, especially in the Eurozone, China is undertaking deep structural reforms, which are met with fierce resistance by vested interests. However, the Chinese leadership is fully aware that the old growth model based on low-added-value manufactured exports and environmental-damaging capital investments is reaching its limit. For this reason, many in the West think that China should accelerate its opening-up, let market forces allocate the country's savings more efficiently and strive for a service and consumption-led economy.

They will continue to be disappointed. While 'opening-up and reform' will remain the Chinese leadership's motto to continue the development of their country and escape the middle-income trap, they will do so in a very gradual and experimental way, and always under the CCP's full control. The market will increasingly play a more decisive role in the pricing mechanism of resources in different sectors, but it will not operate freely. Policymakers in Beijing have started to believe in the virtuousness of market equilibriums, but these will be administratively managed.

This is especially the case in the financial sector. China's financial repression (the control over interest rates in the formal banking system, the capital account and the exchange rate of the RMB) allows the government to decide where to allocate the majority of the Chinese people's savings. The CCP is not about to give up these

13 *The Economist* (2014), 'China's cities: The great transition', 22/III/2014.

important levers. The formal credit circuit (and large parts of the informal one dominated by the shadow banks, which in any case have strong ties to the formal ones) will still be controlled and guaranteed by the CCP. This creates a dangerous moral hazard spiral (indebtedness is skyrocketing), but it assures a less-convulsive restructuring of debt when it is needed.

Services and consumption will gradually represent a larger part of China's GDP, but to undertake this transformation on solid ground the Chinese leadership is convinced that it still needs to develop its infrastructural, industrial and technological capacity. Only by doing so will it enhance the productivity of the Chinese worker and produce the higher-added-value goods and services that are necessary for higher wages, better living standards, higher consumption capacity and the modern tax system necessary to fund public services for the great majority of the population. To pursue this strategy, the leadership will allow more private and foreign capital in order to signal its commitment to openness and garner the productive and innovative capacity of these forces, but this 'alien' capital will most likely not be able to buy more than 20% of the ownership of companies in strategic sectors.

To sum up, China is rebalancing, but it is doing so with Chinese characteristics: on its own terms and at its own pace. Will the ride be smooth? Certainly not. There will be some serious bumps ahead (a banking crisis is a real possibility, and its consequences are unpredictable). But the most likely scenario is that China will continue its development path based predominantly on investments and exports, and that the US and Europe will have to deal with an increasingly stronger (and still illiberal) competitor both economically and politically.