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Rebalancing China's Economy, for Century Weekly

China's 11th Plan and China's 12th Plan (2011-2015) both envisage and plan for a substantial "rebalancing" of China's economy, to move it to a more sustainable path of growth. China internationalized this commitment in the G20 Summit of 2009 in Pittsburgh. At a subsequent meeting in 2011 G20 members "agreed on a set of indicative guidelines that complete the first step of our work to address persistently large imbalances."

Nicholas Lardy, one of America's foremost scholars on the Chinese economy, has just published a book that both expresses his disappointment that little rebalancing actually took place during the 11th Plan and, more importantly, offers his analysis of the actions China needs to take in order to achieve significant rebalancing in the coming years. (*Sustaining China's Economic Growth After the Global Financial Crisis*, Peterson Institute for International Economics, 2012.)

This article will summarize Lardy's diagnosis and his prescriptions, in the thought they should stimulate fruitful discussion in China. Not surprisingly, most of Lardy's points are not new – they have been made for some years, partly by foreign scholars including Lardy himself, partly by Chinese analysts. But Lardy provides a useful overview and synthesis of the issues, suggesting how the different pieces – both of diagnosis and of prescription – fit together.

We can start with Prime Minister Wen Jiabao's remarkable observation to the National People's Congress in March 2007, repeated many times since, that "China's economic growth is unsteady, imbalanced, uncoordinated, and unsustainable." Concrete manifestations of this condition are exceptionally high investment and external trade surplus, relative to GDP, and exceptionally high household savings rates relative to disposable income. "Exceptional" is judged both against China's own past, during the 1990s and early years of the 21st century, and against other countries at comparable stages of development and growth. China also has an exceptionally low ratio of consumption to GDP, and an out-sized housing sector, even after allowing for rapid income growth and urbanization. The large balance-of-payments surplus combined with a (almost) fixed exchange rate conduces to high monetary expansion and inflationary pressure, creating a serious challenge for managing monetary policy by the People's Bank of China, China's central bank.

Lardy's prescriptions for correcting these "imbalances" comprise five elements (and many subcompents): 1) raise both deposit and lending rates imposed on the banks, moving them closer and eventually to market-determined interest rates; 2) appreciate the currency, again moving toward and eventually to a market-determined exchange rate; 3) raise the policy-determined prices of energy – oil, coal, and electricity – to correspond more closely to world prices and to permit a respectable return to investment in the various components of the energy sector; 4) continue the impressive increases in government support for the social safety net, including but not limited to health care and pensions; and 5) raise significantly the dividends paid by state-owned enterprises, as in other countries, and treat them as revenues of the Ministry of Finance rather than sequestering them in a separate, non-budgeted fund.

Increasing bank deposit rates will raise household income directly, since their financial assets are held overwhelmingly in the form of bank deposits. It may also lead to a reduction in saving rates, if households have a savings target that they wish to reach. On both counts households should increase consumption, which is desirable from a macroeconomic point of view. Deposit interest rates corrected for inflation have actually been negative in recent years. This has led many households to put some of their savings into housing – not simply to have better living space, but for investment. About 20 percent of new urban housing is estimated to be vacant. Higher deposit rates will presumably lead to less speculative investment in housing. The challenge will be to have a gradual reduction in housing construction, which as noted above is exceptionally high in China – about twice the level that might be expected. Raising lending rates will also help reduce excessive housing construction, as well as leading firms to be more critical about their investments; low real (inflation-corrected) interest rates lead to excessive and often careless investment.

Appreciating the yuan against the US dollar and other currencies would increase demand for imports and reduce exports, both relative to trend – an absolute reduction in exports is unlikely, unless there is another world recession. Exporters are mainly on the coast, so reducing the profitability of exports would help rebalance the domestic economy geographically. An undervalued currency favors exports of manufactured goods at the expense of investment in domestic activities, particularly the service sector, which is small compared with other countries. Chinese authorities are worried about the impact on employment of discouraging exports. But this concern is misplaced. In fact the service sector taken as a whole is more labor intensive that are typical exports of manufactured goods, and diverting investment to services would create more employment.

Raising interest rates and appreciating the currency are complementary policies, since together they reduce the need the "sterilize" the monetary expansionary effects of the balance-of-payments surplus, which has put considerable strain on China's central bank.

Bringing the price of energy into line with world prices would help the 12th plan objective of reducing the ratio of energy to GDP, with a view to reducing pollution in China, as well as conserving energy, which is consumed abundantly for a country at China's stage of development. It would also help to reduce investment in energy-intensive manufacturing, which contribute to exports but do not provide much employment.

China has expanded the social safety net considerably during the past decade. This should continue, and could be financed partially by raising the dividends of state-owned enterprises, which are low by international standards, and paying those dividends to the ministry of finance to support these increased expenditures.

As noted, most of these proposals have been made for some time. Why have they not been adopted? Lardy speculates about three possible reasons. First, the central government has conflicting objectives, and rebalancing the economy is only one of several objectives; actions to accomplish rebalancing may have been out-weighed by other objectives. Second, local authorities often undermine directives from the central government. It should be noted, however, that many of the rebalancing actions proposed by Lardy do not rely on local governments for execution; interest rate controls and the exchange rate are directly in the central government's hands.

Third, powerful interest groups may have grown up around past policies; these interests, sometimes represented by the Ministry of Commerce in Beijing, resist the indicated changes even though they may be acknowledged to be good public policy because they are not good for the special interests. But if there is any case in principle for dominance of decision-making by the Communist Party, it is that it should be able to decide what is good for the country as a whole and over-ride the particularistic special interests. Lardy's book makes a persuasive case for doing this.