The Transition of China's Development Model

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From 1978 to 2010, China has achieved a continuous high economic growth under controllable inflation pressure. During the 33 years, the average GDP growth was 10.0%, and the average CPI growth was 5.4%.[1] The sustained economic growth enabled China to become the second largest economy in the world in 2010. However, the success in the past naturally cannot guarantee success in the future. The old development model of China is more and more unsustainable under current circumstances, especially after the burst of the global financial crisis. If the Chinese economy cannot change its development model appropriately in time, the fast economic growth in China might come to a halt, and the process of reform and opening up might suffer a reverse.

This paper argues why and how China should change its development model. The paper is structured as follows: The first and second parts analyse the features and consequences of China's old development model. The third and fourth parts discuss why and how China should change its development model.

The Features of China's Old Development Model

There are two main features in China's traditional development model: investment-driven and export-oriented. From 1978 to 2009, the average ratios of private consumption, fixed capital formation and net export to China's GDP were 46%, 33% and 2% respectively. From 2000 to 2009, the above ratios changed to 40%, 39% and 5% respectively, which demonstrated that China's economic growth relied more heavily on investment and export in 2000s compared with 1980s and 1990s.[2]

The Chinese government has always appointed industrialisation as a top-priority on its development agenda. To stimulate investment, the Chinese government has been pushing down various domestic commodity prices, including energy prices and environmental costs. Moreover, the Chinese government has been keeping an artificially low interest rate environment through the interest rate regulations. Both the low commodity prices and the

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1 The data comes from CEIC.

2 Ibid.

low interest rates pose an implicit welfare transfer from the commodity suppliers or creditors (the households) to the commodity consumers or debtors (the corporations).

Once the Chinese government adopted a way of strong investment combined with weak domestic consumption, the Chinese economy had to rely on exports to absorb the excess capacities. To promote the growth of exports, the Chinese government has been maintaining a significantly undervalued RMB exchange rate. The undervalued RMB exchange rate and the artificially low domestic commodity prices made China's manufactures very competitive in global market. Moreover, in the past decades, the dependency ratio in China was very low. The demographic surplus enjoyed by China indicates a nearly infinite labour supply, especially for unskilled labours released by the rural area, which help to make China's exporting goods more competitive in price.

The Consequences of China's Old Development Model

The old development model brought China not only a high growth era, but also many negative byproducts. As time goes by, the negative consequences of China's old development model become more and more prominent.

Firstly, the growth of private consumption is much lower compared with investment and export. The ratio of private consumption to GDP declined from 51% to 36% in the past 20 years (1989 to 2009).[3] An economy with high investment ratios and low private consumption ratios tends to be more and more fragile as this economy grows up to be a large economy, or in times of global economic turbulence, because it will be more and more difficult for this economy to find enough external demand to absorb the excess capacity. If the excess capacity cannot be absorbed, the profitability of fixed asset investment will decline significantly, which will result in the low profitability of enterprises and the non-performing loans of commercial banks.

Secondly, China has a continuous twin surplus in its balance of payments since 1999. The continuous twin surplus is very uncommon, because most countries have balanced international payments such as a current account surplus accompanying a capital account deficit (such as Japan and Germany), or a current account deficit accompanying a capital account surplus (such as the United States). Behind the twin surplus, there is a huge distorted resource allocation, i.e. the accumulation of over 3 trillion USD foreign exchange reserve. It is ridiculous for China (a developing country) to lend such a huge amount of money to very rich countries such as America and Eurozone. Moreover, the value of China's foreign exchange reserve will suffer huge loss if the global inflation goes up or if USD depreciates sharply.

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[3] Ibid.

Thirdly, there is a significant industry imbalance in China. Generally speaking, China's manufacturing industry (tradable sector) is in some extent overdeveloped, but the service industry (non-tradable sector) is clearly underdeveloped. Two factors have caused the industry imbalance. One factor is the undervalue RMB exchange rate. Because the RMB exchange rate is also the relative price between tradable and non-tradable goods, the undervalued RMB exchange rate means that the tradable goods sector will have a persistent competitive advantage over non-tradable goods sector, which will induce more resources to flow into tradable sector, thus hampering the development of non-tradable sector. Another factor is the state-owned enterprises (SOE's) monopoly in many highly profitable service sectors such as telecommunication, railway, finance, medical care, education, etc. The state monopoly in many service sectors is also a key factor for China to have SOEs, but weak small and medium sized enterprises.

Fourthly, although the Chinese government's fiscal position is better than that of many developed countries such as United States and Japan, Chinese economic growth relies heavily on loose monetary policy. As a result of this continuous loose monetary policy, China's M2 to GDP ratio reached 182% in 2010, which is the highest among the major large economies. A high M2 to GDP ratio demonstrates that Chinese economy is highly monetized. If the Chinese government cannot manage the economy well enough, there will be a serious inflation or a huge asset price bubble sooner or later.

Why China Has to Change its Development Model?

Since the burst of U.S. subprime mortgage crisis and European sovereign credit crisis, the external environment of China has been changing dramatically. The Chinese government suddenly found that the traditional growth momentums such as export began to vanish; therefore, China's development model should change to sustain fast economic growth in the future.

The external demand for Chinese manufactures is shrinking after the burst of the global financial crisis. The vast appetite of U.S. consumers for global goods before the crisis had been proven to be a bubble. After the crisis, the U.S. households entered a stage of deleveraging, which meant that they cut the liabilities and decreased consumption. The deepening of the European debt crisis has already resulted in a slower economic growth for Eurozone countries. The shrinkage of external demand will definitely impact China's export growth. If China's private consumption cannot rise accordingly to absorb the capacity of manufacturing sector, there will be problems of excess capacity. On the one hand, the efficiency and contribution of investment will decline. On the other hand, the slowdown of export growth will impact overall economic growth and employment.

Moreover, there will be excess capacity not only in fixed asset investment, but also in infrastructure investment. After the burst of the U.S. subprime mortgage crisis, to stimulate the economic growth, the Chinese government adopted a fiscal rescue package amounted 4 trillion RMB, most of which were invested in infrastructures such as high speed railways, express ways and airports. Lots of evidence shows that there has already been a bubble in the infrastructure construction in the past several years. If the new infrastructures cannot be utilized enough to cover the principal and interest of relating loans in the near future, the investment vehicles sponsored by the local government, which did the infrastructure investment will go to bankruptcy. The local government will suffer large fiscal deficit and a severe debt burden, and there will be a new wave of non-performing loans for China's policy and commercial banks.

The high investment paradigm of China has begun to face the bottleneck of energies and commodities. If China was still a small economy, the demand from China would not cause large fluctuations of global energy and commodity prices. But as China is becoming one of the largest economies around the world, China's demand is becoming one of the major forces pushing up and down global commodity prices. When the Chinese economy is heating up, the strong demand from China will push up global energy and commodity prices, which will result in the rise of costs of raw materials and other inputs, and the slowdown of economic growth eventually. The fact that China's term of trade has been deteriorating in the past decade, is proof.

China's demographic surplus is vanishing. As the result of birth control policy which was adopted over 30 years ago, China's demographic structure is aging at a very fast speed. The old dependency ratio of China will keep rising in the next decades of years, which means that the supply of young labourers will decrease gradually in the future. On the other hand, the transfer of rural labours to urban areas will be completed in the next ten or twenty years. The change of demographic structures will lead to the rise of labour cost, which will weaken the price competitiveness of Chinese manufactures. If not managed well, the sustained rise of labour cost might trigger the wage price spiral, even leading to an uncontrollable inflation.

China's huge foreign exchange reserve might suffer new shocks such as the USD's dramatic depreciation in the mid-term. The U.S.'s government debt to GDP ratio has reached 90% and is still rising. U.S. government has a very strong incentive to let the USD depreciate, which could not only decrease the real debt burden, but also stimulate net export. Considering that about two thirds of China's foreign exchange reserve is invested on USD denominated assets, the Chinese government will suffer a great capital loss if the USD depreciates against major currencies dramatically.

The over loose monetary policy should return to neutral or even properly tight as soon as possible. After the burst of the global financial crisis, the Chinese government adopted an overly loose monetary policy. The RMB bank lending reached 9 trillion RMB in 2009, which was almost twice of 2008 and three times of 2006. The huge banking credit not only resulted in the surge of property prices, but also exacerbated inflation pressure. At present the real deposit interest rate has been negative for dozens of months. To fight with inflation and to control asset price bubbles, the Chinese government should raise interest rates significantly. However, the interest rate hikes are suffering strong opposition from major debtors such as local governments and SOEs.

How Should China Change its Development Model?

The objective of the Chinese government is to change its development model from investment-driven and export-oriented to domestic consumption-driven so as to secure a more balanced and sustainable economic growth.

Firstly, the Chinese government should promote the reform on the income distribution inequality at two levels. One level is the income distribution between the household, government and corporate sectors. In the past twenty years, the growth of China's household income lagged significantly behind that of government revenue and corporate profit. To increase the share of national income enjoyed by the household, the Chinese government should reduce the overall tax burden of the household. Moreover, the SOEs should pay a higher proportion of their profits after tax to the government as dividends, and then the government should pay the dividends to the households (e.g. by injecting the money into social security accounts). Another level is the income distribution inside the household sector. The Chinese government should change the personal income tax from wage based to wealth based. For example, Chinese government should levy capital gain tax on property and stock shares transactions.

Secondly, the focus of government expenditure structure should change from fixed asset investment or infrastructure investment to the provision of social public goods such as education, medical care and social security. A large proportion of Chinese household savings is precautionary saving. If the uncertainties about the income and expenditures in future could be mitigated significantly, the Chinese households will be very glad to consume more goods and services.

Thirdly, the domestic factor prices should be liberalised as soon as possible, which includes utility prices, commodity prices, environmental costs, exchange rate and interest rate. The prices of China's manufactures could only reflect its real comparative advantages after all the factor prices are fully liberalized. The liberalisation of domestic factor prices could not only decrease the investment growth (to make Chinese growth momentums more balanced), but also make China's international payments more balanced (the current trade surplus will shrink). However, it will be very difficult for the Chinese government to liberalise domestic factor prices, because of the strong oppositions from interest groups. For example, the reform of RMB exchange rate formation mechanism (which will naturally result in the appreciation of RMB exchange rate) always faces the strong opposition from exporters, local government in coastal areas, and even the Ministry of Commerce. The liberalisation of interest rate is even much more difficult than the reform of RMB exchange rate. Not only the major debtors such as local government and SOEs will oppose it, but also the commercial banks will argue against it, because the interest rate liberalisation will result in the shrinkage of interest rate spread, thereby hurting the profit margins of commercial banks.

Fourthly, the monopoly of SOEs in many critical and profitable service sectors should be broken. The monopoly of SOEs not only exacerbated the industry imbalance (underdeveloped service sector because the SOEs in monopoly have very weak incentive to increase investment), but also resulted in weak small and medium sized enterprises. The underdeveloped service sector is also a reason why China's household consumption ratio is so low: The household's consumption of manufactured goods is relatively sufficient, but the household's consumption of services is significantly lower, because of the limited supply, the bad quality or the high price. Therefore, the opening up of those service sectors to private capital could not only mitigate the industry imbalance, but also stimulate domestic private consumption.

Finally, the distorted export-encouraging and FDI-attracting preferential policies should be abolished. The preferential policies include the counter-cyclical tax rebate and the much lower corporate tax burden for foreign companies. Those policies reflected the misallocations of domestic resources (Chinese provide subsidies to foreigners or foreign companies), and resulted in the current and capital account surplus. To make the Chinese economic growth more sustainable and to let Chinese households and corporations enjoy more growth surplus, the Chinese government should abolish those distorting preferential policies. The tax rebate should become neutral, not counter-cyclical. The foreign companies should face the same operating environment as the domestic companies.

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