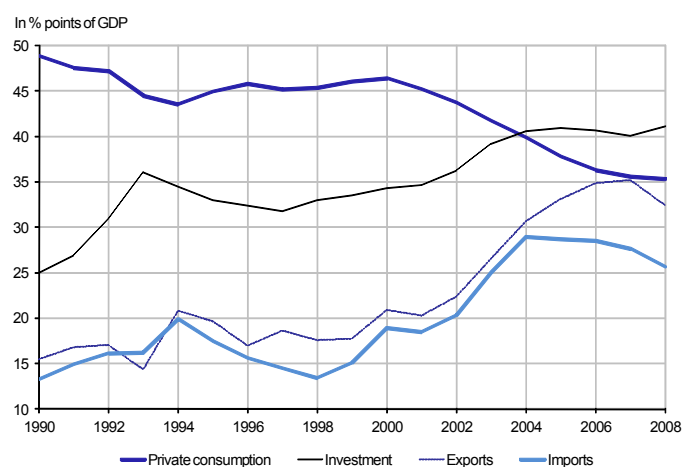


A more balanced growth for China: challenges and prospects

- Getting gradually a more balanced Chinese growth by fostering consumption is instrumental in achieving global economic stability. It would help in lowering gradually China's current account surpluses and reducing global imbalances.
- The stabilisation of China's working population between now and 2015, coupled with the drying up of much of the pool of rural migrants (mainly men aged 18-30), are expected to lead to labour shortages. These factors could push up wages, and could thus partly contribute to this rebalancing in the medium term.
- The fiscal stimulus plan released in November 2008 focussed essentially on infrastructure, and the "universal" healthcare insurance plan, while a step in the right direction, relies probably too heavily on public investment (hospital building in the main place).
- The structural reforms required to bring about this rebalancing are pretty well identified. They consist notably in: (i) improving the redistribution of company profits and a nominal appreciation of the currency, so as to boost Chinese consumers' purchasing power; (ii) better welfare policies, in order to reduce precautionary savings; and (iii) developing and liberalising the financial markets, to enable households and SMEs to gain access to them.

This study was prepared under the authority of the Directorate General of the Treasury (DG Trésor) and does not necessarily reflect the position of the Ministry for the Economy, Industry and Employment.

Change in the share of the different components of Chinese GDP



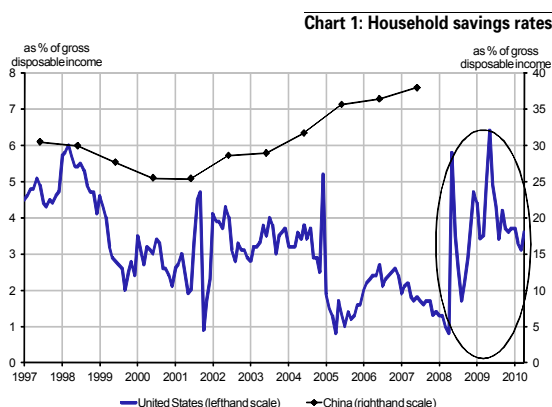
Source: DG Trésor calculations

1. A rebalancing of global growth is much needed. It requires more sustained Chinese household consumption

Failures of financial regulation are one essential cause of the crisis from which the global economy is now gradually emerging; but the crisis would not have occurred, or would have been less severe, had the early years of this century not been marked by major macroeconomic imbalances. **These imbalances have their roots in two complementary factors, namely:**

- **Excessive consumption in the United States**, spurred by the Fed's loose monetary policy and by the dollar's reserve currency role, which allowed the United States to take on debt without significantly affecting its exchange rate;
- **Excessive saving in China**, leading to large current account surpluses, brought about by an undervalued currency. Thanks to these current account surpluses, China has accumulated more than \$2,000 billion in reserves. These reserves have been used among others to finance the US budget deficit by buying US Treasury bonds.

These imbalances created a global glut of liquidity, pushing down interest rates and fuelling borrowing in the United States, which led to the property bubble whose bursting helped trigger the crisis. It is therefore essential to reduce these global imbalances if we are to avoid recreating macroeconomic conditions leading to further crises. This notably entails a rise in US savings and stimulating domestic demand in China.

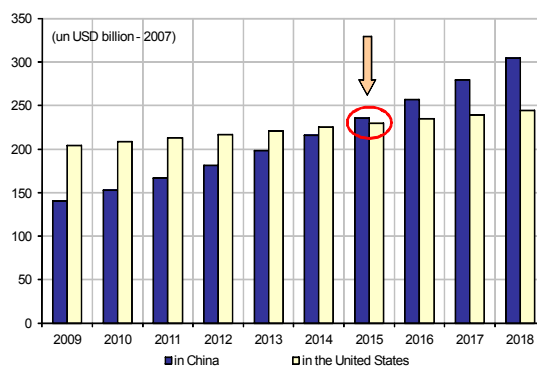


In the United States, part of the adjustment has already taken place: the model whereby growth is driven by the US consumer (and, ultimately, credit), has suffered a heavy blow and the process of US household debt reduction now in progress has pushed up America's household savings rate (see Chart 1).

Another driver of global growth is needed in the short to medium term to ensure this adjustment does not spark a protracted global economic slowdown. Consumption in the emerging countries, China especially, could deliver this new driver.

Given the Chinese economy's strong growth, it is very likely that Chinese private consumption will contribute more than US consumption to global economic growth in the coming years (see Chart 2). A progressive and spontaneous rebalancing of global consumption is underway. But if the long-term decline in consumption's share of US GDP is not to damage global activity for a protracted spell of time, the share of private consumption in Chinese GDP will need to offset this decline to a large extent. In other words, the Chinese growth model needs to be redirected towards private consumption.

Chart 2: Annual growth in household consumption



Sources: Prasad 2009¹, China US Business Council, BEA, DG Trésor calculations

Interpretation: Annual growth in Chinese household consumption could overtake that of American households some time around 2015 (the share of private consumption in GDP is assumed to be constant, and GDP is assumed to grow at an annual rate of 2% in the United States and 9% in China).

2. Apart from a more balanced world demand, the Chinese growth model will hardly retain its momentum in the medium term without a shift in favour of household consumption

Over the years, China's growth has become increasingly dependent on investment and exports. During the 2000s, investment and net foreign trade respectively accounted for 48% and 24% of China's growth in real terms, versus 35% and 7% in the 1990s. Consequently a rebalancing of China's growth in favour of private consumption is necessary for the Chinese economy itself.

2.1 China's growth may gain from relying less on exports

Over the past decade, China's growth has to a very large extent been driven by its tradable sector. Thus between 2002 and 2007 net foreign trade contributed to some 3 percentage points to annual growth (which itself averaged +10.7% per

year over the period). In 2007, exports accounted for 35% of GDP, which is a particularly high percentage for a country the size of China². A recent IMF working paper³ shows that it would be very costly for China to maintain a form of growth so heavily dependent on exports (especially given that global demand could remain persistently depressed):

- China would have to increase its market share considerably in order to retain such an heavily export-dependent growth; this could be achieved only by accepting steep declines in export prices. That could be achieved, theoretically, through productivity gains, lower profits and/or higher export subsidies, but each of these strategies raises difficulties, since:

(1) "Rebalancing Growth in Asia", NBER Working Paper 15169.

(2) Compared with 12% for the United States and 18% for Japan (2007 figures).

(3) "Is China's Export-Oriented Growth Sustainable?" Kai Guo and Papa N'Diaye, IMF Working Paper, 2009, no. 172.

- productivity and marginal returns on investment have declined in recent years;
 - the crisis hurt Chinese exporters' operating margins, and they are likely to be hurt further by labour market pressures. So it will be hard for these firms to trim their margins still further in order to improve their competitiveness, especially as everyone is expecting the Yuan to rise in the coming months;
 - subsidies would exert an "excise effect" and create price distortion that would fuel still further the over-investment already observed in the manufacturing sector, lead to increased bad loans, ratchet up trade tensions (through protectionism), and ultimately drag down growth;
 - China's export sector's competitiveness also depends on the intensive use of cheap labour, thanks to dynamic labour supply in rural areas. However, internal migratory flows have shown signs of dwindling since 2009, because of low wages in the coastal industrial regions. This phenomenon is already giving rise to labour shortages in these regions, and will lead to two kinds of adverse adjustment for Chinese competitiveness, i.e.: i) rising wages in the coastal regions, and ii) delocalisation of export industries to inland regions or abroad.
- Nor are the other possible strategies for helping to boost China's market share likely to enable China to hold onto its growth model: neither moving upmarket, new industries, changing the export mix, increasing the Chinese made share of value added in Chinese exports, nor a spurt in globalisation, would be enough to boost China's market share sufficiently. An analysis of past growth in South Korea and Japan, whose economic models also depended on exports, suggests that these measures would fail to generate the market share gains China needs.
 - Finally, China could boost its market share by pushing down its effective nominal exchange rate, but that would accentuate all of its internal imbalances and create serious tensions with its trading partners.

2.2 China's investment level is very high, and part of it is inefficient

The imbalances in the Chinese economy are not only external (i.e. exports v. domestic demand); they are also, and possibly even more so, internal (i.e. investment v. consumption). It could bring about a dynamically inefficient growth. That is because investment accounts

for a large proportion of GDP, and this share has grown in recent years (to 44% at present, one of the highest ratios in the world, versus 35% in 1990), reflecting widening internal imbalances. Thus the figure for capital formation for 2009 could overtake that of the United States for the first time (whereas China's private consumption represents only a sixth of American consumption).

2.2.1 Chinese investment could be excessive⁴

There are precedents for such high rates of investment in emerging economies: Singapore in the 1980s and South Korea in the 1990s both experienced comparable investment rates⁵. In a transitional phase like the one China has been through, the capital depreciation rate may be relatively high, in which case it is logical for the investment rate to be high also; what makes China distinctive, rather, is that this period of high investment has lasted much longer than those seen previously in the other Asian emerging countries.

One criterion for determining whether or not the level of investment is excessive is the return on capital: where investment is excessive, the rate of return on capital is naturally lower than its long-term average. Yet the OECD⁶ has found a substantial rise in China's rate of return on capital between 1998 and 2003, before stagnating at around 12% for private firms (excluding property).

However, to mean over-investment, a fall in the productivity of capital must be coupled with a significant parallel decline in the growth rate of total factor productivity (TFP). It is not enough to look at the productivity of capital alone: to be sure, in the short run, a decline in the productivity of capital is a sign of excessive investment, but in the longer run this decline could be interpreted in several different ways. Two extreme interpretations are: either this is a matter of a capital/labour substitution, or there is an excessive accumulation of capital, which would be identified by a slowdown in total factor productivity (see Box 1⁷).

Because of the relative reliability of China's statistics and the variety of methods used to correct their imprecision, the literature is not unanimous, but the majority of available estimates point to a slight slowdown in China's TFP in the recent period⁸. **Consequently, the data are not inconsistent with the existence of a slight excess of total investment.** In other words, China's stock of capital might be above its "golden rule" level

(4) See Delozier-Hochraich, "L'investissement en Chine est-il excessif?" (Is investment in China excessive?), *DPAE no. 108*, May 2006.

(5) The fact that South Korea was severely hit by the 1997-98 Asian crisis does, however, suggest that investment had been excessive in this precise case.

(6) "China Economic Survey, 2005" and "China Economic Survey 2009", OECD.

(7) See *DPAE no. 108*, *ibid.*

(8) Bosworth and Collins find that productivity grew faster after 1994 than in the period 1978-1993. But many other articles point to a slowdown in TFP, as in the case of He, Jianwu and Louis Kuijs, or of Zheng et al. together with Perkins, who find a slowdown in TFP in 1995. Wu finds a slowdown in TFP as from 2001 [see Bosworth and Collins (2007), Accounting for Growth, Comparing China and India; He, Jianwu and Louis Kuijs (September 2007), Rebalancing China's economy - modeling a policy package, *World Bank China Research Paper No. 7*, Beijing, see Zheng J., A. Bigsten and A. Hu (2009), Can China's growth be sustained? A productivity perspective, *World Development*, Vol. 37, no. 4; Perkins, D. and T. Rawski (2008), Forecasting China's Economic Growth to 2025, in L. Brandt and T. Rawski (eds), *China's Great Economic Transformation*, Cambridge University Press; and Wu, Y. (2008) The role of productivity in China's growth: new estimates, *Journal of Chinese Economic and Business Studies*, Vol. 6, no. 2].

Box 1: Links between trends in capital productivity and total factor productivity (TFP)

Over the long run, on a "balanced growth path", the capital/GDP ratio (K/Y) is constant and capital grows in line with GDP. In the short to medium run, a substitution of capital for labour can lead K to grow faster than Y . But this substitution will not affect TFP if the substituted capital is used fully and efficiently.

This is because, if the production function is written $Y = A \cdot K^\alpha \cdot L^{(1-\alpha)}$ where L designates labour, A technical progress, and α the share of the remuneration of capital in value added, then the rate of growth of TFP is written

$$\Delta(Y/K) = -(1-\alpha) \cdot [\Delta(K/L) - \Delta A / (1-\alpha)]$$

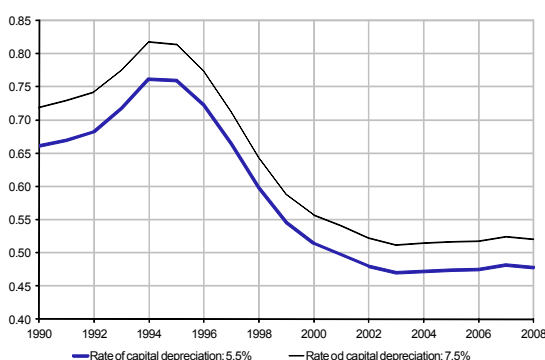
where Δ designates the logarithmic derivative. ΔA being the rate of growth of TFP. On a balanced growth path, capital grows in line with activity, hence $\Delta(Y/K) = 0$ and $\Delta(K/L) = \Delta A / (1-\alpha)$. Consequently $[\Delta(K/L) - \Delta A / (1-\alpha)]$, which represents variations in the capital/labour ratio unexplained by technical progress, measures the effect of substituting capital for labour; this substitution can therefore account for a fall in the productivity of capital with no significant impact on the rate of growth of TFP (ΔA).

However, a decline in the productivity of capital could also stem from an accumulation of idle capital in the economy; in that case, labour productivity would be unaffected, whereas TFP would be diminished. That is because we would then have $Y = A^* \cdot K^* \alpha \cdot L^{(1-\alpha)}$ where K^* is the capital actually used, whereas the capital measured is $K > K^*$. The resulting TFP is then $\Delta A^* = \Delta Y + (1-\alpha)\Delta L - \alpha\Delta K^*$ which is greater than the TFP that would result with the surplus idle capital $\Delta A = \Delta Y - (1-\alpha)\Delta L - \alpha\Delta K$, the skew on TFP depending on the quantity of idle capital: $\Delta A - \Delta A^* = \alpha(\Delta K^* - \Delta K)$.

Summing up, a decline in the productivity of capital accompanied by a fall in the rate of growth of TFP reflects an accumulation of idle capital, whereas a decline in the productivity of capital with no change in the rate of growth of TFP probably signals a simple capital/labour substitution.

This reasoning is based on the assumption that the Chinese economy's production function remained unchanged over the period. In the case where the production function is modified (with a change in the share of the remuneration of capital in value added, for example), the calculations of TFP are indeed skewed.

Chart 3: China's capital productivity



2.2.2 Whatever the case, investment by State firms clearly looks excessive

That investment by State firms is excessive can be seen through a number of indicators. Leaving aside the 100 largest State firms, most of which operate in the mining industry or in sectors where private competition is impossible, their profitability is particularly low. It is also in these firms that TFP is growing slowest⁹ and most dispersed¹⁰. These elements probably reflect major distortions in capital allocation, with excessive quantities of capital being allocated to certain State firms. According to Dollar and Wei¹¹, these distortions in the allocation of capital to State firms have a large and negative impact on GDP. According to their simulations, if capital were allocated more efficiently, total investment could be reduced by 5 percentage points of GDP without affecting China's growth.

2.2.3 Misallocation of investment in China is giving rise to surplus capacity and fostering an increase in bad loans

Consequently, the main problem with China's investment is its quality, with an disequilibrium between excessive investment in sectors that are already over-producing and insufficient investment in others (the service sector). The Chinese authorities acknowledged the existence of surplus capacity at the end of September 2009, when they banned bank loans, together with equity and bond financing, for firms in six particularly badly-affected sectors, namely steel, cement, wind power, coal-based chemicals, flat glass and silicon.

Low returns on certain Chinese investments could lead to a rise in the percentage of bad loans. Lending soared 122% in 2009, to RMB 9,590 billion, making a rise in bad loans practically inevitable in the medium term. Although the official bad debt ratio in June 2009 was 1.8%, it is likely higher, closer to 5% or 6% according to Fitch. The China Banking Regulation Commission has accordingly tightened its control over local authorities' investment vehicles, with their opaque practices and high credit default risks, in the Commission's view. The Commission has also raised banks' non-performing loan cover obligations from 135% to 150%.

These measures are helping to reduce the systemic risks associated with bad loans, but it is clear that investment cannot continue to be a long-term source of growth for China without generating further over-capacities and a dangerous rise in bad loans. Consequently, to be sustainable in the long run, **China needs to rebalance its growth primarily by increasing the share of private consumption in GDP.**

(9) See OECD, *China Economic Survey 2009*.

(10) See Hsieh, C.-T and P. Klenow (2009), Misallocation and Manufacturing TFP in China and India, *Quarterly Journal of Economics*, forthcoming.

(11) Dollar, D. and S. Wei (2007), Das (Wasted) Kapital: Firm Ownership and Investment Efficiency in China, IMF *Working Paper*, WP/07/9.

3. Redirecting China's growth towards household consumption will require structural reforms, and these have been clearly identified

3.1 China's weak consumption results from excessive household savings, and even more so from low income growth

The "weak" state of Chinese consumption is relative, in the sense that it has grown by 8% annually, on average, over the past decade, which is much faster than in most other countries. However, the share of private consumption in GDP fell from 49% in 1990 to 35% in 2008¹². Several factors help to account for this:

- **Rising household savings rates:** household savings rose from 21% of GDP in 1998 to 24% in 2008. An important reason for this high level of saving is the need for **precautionary savings to pay for expected welfare-related expenditures such as healthcare, education and, to a lesser extent, pensions**, given

the large outlays involved and China's relatively undeveloped financial system, which makes it hard for individuals to borrow. Widening inequalities also help to account for the rise in the household savings rate over the past decade: higher income earners, who have increased their share of the total, also have the highest propensity to save. For some economists, life-cycle theory calls on other factors to account for the high rate of Chinese savings, such as the demographic profile and the sharp rise in household incomes (see Box 2). On this view, proactive governmental welfare reforms would not be sufficient to bring China's household savings rate back down to the level of the leading emerging countries.

Box 2: In life-cycle theory, the rate of income growth and demographics account for the high level of savings in China

According to life-cycle theory, the national savings rate S/Y depends not on per capita income but on long-term income growth^a.

This result can be demonstrated more simply if we start by assuming an absence of variation in the population structure. The model that leads to this result starts from the classical postulate that individuals choose to allocate the resources available to them optimally between present and future consumption over their lifetime. Changes in income over time are assumed to be the same for all generations, and the savings/income and wealth/income ratios depend solely on age (and not on time, nor on the level of income over a whole lifetime). Aggregate income grows at a constant pace g over time.

We consider in the first place the case in which growth is due solely to a rate of population growth g , with a constant average per capita income. Over time, the number of individuals in each age group grows at a rate g . For each age group, therefore, consumption and income grow at a rate g , as do total consumption and total income. Since the wealth/income ratio depends on age alone, wealth too grows at a rate g for each age group, and the same holds for total wealth. Thus, for any value of g , national wealth is proportional to income according to $W=wY$, where w is a constant independent of income (although it may be dependent on g). Since savings are the growth in wealth, we may deduce from this:

$$S/Y = \Delta W/Y = w\Delta Y/Y = wg$$

Consequently, the savings rate is independent of income, being dependent solely on the rate of income growth. **For wealth to grow at the same rate as income, the faster the growth rate, the higher the savings rate needs to be.** In particular, if income were stable, wealth would be too, and savings would be nil.

Similar conclusions can be drawn in the case where growth is driven by productivity gains (i.e. with rising per capita income). The source of growth has little impact on the relationship between savings and growth. The value of w , for a given value of g , differs little regardless of whether g comes from stable population growth, productivity gains, or a combination of the two. The simplified savings function of the life cycle model is written:

$$S/Y = s'_0 + s'g + e$$

where s'_0 is close to 0, s' is significantly positive, and e an error term. The savings rate thus depends positively on growth.

These results remain valid when one allows for changes in the structure of the population. Modigliani shows that, in the case of China, the savings rate thus also depends positively on the ratio of the population in work to the population too young or too old to be in work. This ratio has risen sharply since the mid-1970s owing to the introduction of the one-child policy, which has led to a fall in the proportion of young people in China's population.

Ultimately, according to life-cycle theory, if China's household savings rate is high today, it is because China's growth rate is high and because the one-child policy is obliging China to save heavily in order to prepare for the ageing of its population.

- a. This result was evidenced in: "Life Cycle, Individual Thrift and the Wealth of Nations", MIT Press, 1989. The results specific to China are discussed in "The Chinese Saving Puzzle and the Life-Cycle Hypothesis," Modigliani and Cao, *Journal of Economic Literature*, Vol XLII, mars 2004.

- However, **the main cause of the decline in the ratio of private consumption to GDP in the past decade is the falling share of national income allocated to households**, whereas the share allocated to profits has risen; in other words, **the rise in China's national savings is mainly traceable to firms, rather than to households**. The relatively sluggish growth in household incomes is accounted for by a) the fact that Chinese growth has created relatively few jobs, being concentrated in the export sector and heavy industry, both of which are capital intensive (low interest rates and a low

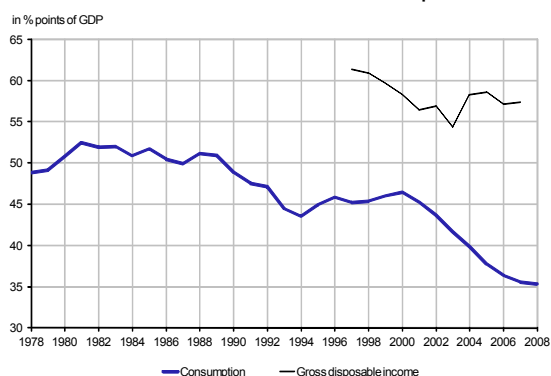
exchange rate having encouraged the growth of capital intensive sectors), and b) the fact that most State-controlled firms do not pay dividends.

- Finally, since 2005, **public administrations have considerably increased their contribution to the growth in national savings**¹³, thanks to capital gains realised on land and property transactions by local administrations and to higher social insurance contributions levied on households, which are not fully redistributed for the time being.

(12) Compared to 50-60% in most of the rest of Asia, and 70% in the United States.

(13) According to recently-published Flow of Funds data for 2007 (cf. *Bulletin Économique Chine* no. 21, January 2010: http://www.ambafrance-n.org/IMG/pdf/bulletin_economique_chine_no21_janvier_2010_.pdf).

Chart 4: Chinese household consumption and income

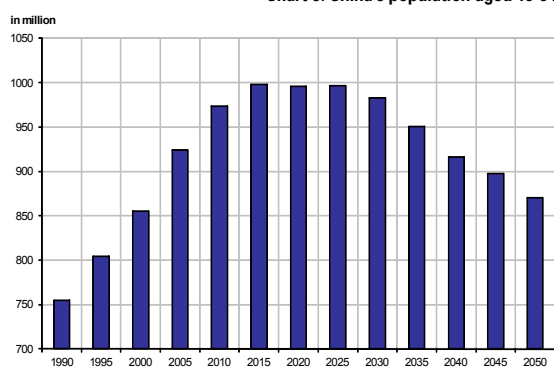


3.2 Working population trends and a slowdown in labour migration could help to rebalance the Chinese model

Current demographic trends in China could help to boost household consumption in the medium term, due to the following factors:

- As a result of the **one-child policy** introduced at the end of the 1970s, the **working population** is expected to start peaking between now and 2015, and will actually start declining significantly from 2025 onwards (Chart 5).

Chart 5: China's population aged 15-64



Source: UN Population Division (2008 projections - baseline scenario)

- It is estimated that the "reserve army" of rural migrants has largely been depleted, according to a study by the Chinese Academy of Social Science¹⁴; the authors estimate that a "survey of 2,749 rural Chinese villages found that three-quarters of the villages had exhausted their young human resources," the majority of migrants being men in the 18-30 age group. Consequently, internal labour market-driven migration could

dwindle in favour of migration aimed at reuniting families.

The combination of these two demographic phenomena is already causing labour shortages, which is conducive to higher wages and, ultimately, household consumption. It is hard to quantify the likely effects of population trends on household income, however. Whatever the case, it is unlikely that demographics alone can rebalance China's growth, which means proactive measures will be necessary.

3.3 Boosting China's household consumption requires some structural reforms

Given the identified causes of the (relative) structural weakness of Chinese household consumption, the following reforms will be needed in order to rebalance growth in favour of consumption.

1. **Improving welfare policies (i.e. healthcare, education and pensions)**¹⁵ so as to reduce households' precautionary savings; this means a major effort by the authorities (given the amounts involved) and a change in household behaviour, whose benefits will be visible only in the medium run. The government doubled spending on healthcare, education and social security between 2005 and 2008, but this is still low, at 6% of GDP (compared with an OECD average of 25%). Moreover, the State has the financial wherewithal to act, thanks to the increase in public administrations' savings between 2005 and 2007¹⁶.
2. **Developing and liberalising the financial markets.** This notably entails building up the bond and equity markets, and liberalising interest rates.
 - (i) extending savings instruments accessible to households would enable them to boost their incomes;
 - (ii) the development of insurance products would help to limit precautionary savings;
 - (iii) improving households' access to credit would help to retrieve liquidity constraints and to foster their propensity to consume;
 - (iv) developing financial markets would provide an alternative to internally-financed investment¹⁷, for SMEs especially, thereby limiting their need to save;
 - (v) **freeing interest rates**¹⁸ would help to improve the allocation of capital; it would raise the cost of investment (especially for State-controlled firms¹⁹) and could limit excessive investment²⁰, while at the same time boosting household incomes (through higher interest rates on bank deposits).
3. **Improving the redistribution of firms' profits**, with a view to reducing their "over-savings" and boosting household incomes. In particular, the authorities could promote more employee-friendly labour legislation, raise social insurance and tax levies, and could encourage the distribution of higher dividends, either directly to households or to the government in the case of State enterprises (to enable them to be used in welfare programmes aimed at households and no longer as subsidies to

(14) Fang Cai, Yang Du, Meiyang Wang, Migration and Labor Mobility in China, Institute of Population and Labor Economics, Chinese Academy of Social Sciences, April 2009.

(15) Increasing welfare transfers and investment in human capital, unifying the pensions and welfare protection systems, and abolishing the link between doctors' pay and what they prescribe, for example.

(16) According to the most recent available data.

(17) At present, 60% of investment is funded internally, with bank loans funding the remainder; bond funding is practically non-existent.

(18) In particular abolition of the constraints represented by floor rates for loans and capped rates for deposits.

(19) According to BBVA, the average borrowing rate between 2001 and 2005 was 2.5% for a State enterprise, 4% for a foreign firm, and 10% for a private Chinese firm.

(20) Liberalising the prices of other subsidised industrial inputs such as energy, water and land could go hand in hand with the freeing of interest rates, and would have the same effect in terms of raising the cost of investment.

firms). These payments could lead to a significant rise in consumption if households were to consume a high proportion of them.

In addition, tackling monopoly rents²¹ would boost competition and so contribute to the transfer of a portion of corporate profits to households through lower prices.

What is more, abolishing restrictions on migration between town and countryside²² and thus increasing the supply of labour in the towns could also boost household incomes and consequently consumption²³.

4. **Allowing the renminbi to appreciate:** this exchange rate policy would serve several objectives simultaneously, namely:

- (I) reducing incentives to steer investment towards the export sector (which would diminish the risk of creating overcapacity in the context of persistently depressed global demand), and redirecting it towards the domestic sector (which would boost the jobs content of growth in the service sector notably);
- (II) boosting Chinese consumers' purchasing power;
- (III) reducing global imbalances via the reduction in China's trade surplus²⁴.

This policy could be further supplemented by **facilitating access to the Chinese domestic market** for foreign firms.

3.4 Shifting growth towards private consumption would have a positive impact on employment in the long run

Shifting Chinese growth towards consumption presupposes an increase in demand for both existing and new services, as well as steering production of tradable goods towards the production of locally consumed goods as well as services. A recent IMF study²⁵ suggests that, in the long run, rebalancing Chinese growth in this way would have a positive impact on jobs, particularly on the creation of jobs in the sheltered sector, with a more limited impact on jobs in the export sector.

In the short term, the adjustment could lead to a fall in net job creation owing to leads and lags in hiring and the time needed for infrastructures to become operational. However, this phenomenon could be limited thanks to the characteristics of the Chinese economy²⁶ and these costs could in any case be alleviated by policies aimed at limiting their transient effects, e.g. through training programs to reduce the skills mismatch between labour supply and demand, facilitating labour mobility between sectors and regions in order to reduce adjustment lead times, or even by providing temporary income substitution measures.

4. The Chinese government's current measures could be supplemented and deepened

Even before the crisis, the Chinese authorities have introduced a certain number of measures aimed at starting to rebalance the Chinese growth model (see Box 3).

Box 3: Measures taken between 2005 and 2008 aimed at rebalancing the Chinese growth model

Before the crisis broke, the Chinese authorities had clearly hinted at their concern over the imbalanced nature of China's growth^a and taken steps to remedy these imbalances by:

- **taxing public-sector enterprises** and promulgating a **new, more employee-friendly labour law** to promote the redistribution of profits to households;
- adopting **tougher environmental standards** and a **more selective approach to projects**, particularly in sectors suffering from overcapacity, thus rationalising investments;
- **letting the renminbi rise** and **halting VAT refunds on exports**, thereby reducing the profitability of exports of low-value-added goods, encouraging producers to move upmarket and redirect their output towards the domestic market;
- **developing and liberalising the financial markets** had already been put in hand, the most significant reforms dating from 2005-2006^b.

a. "The biggest problem with China's economy is that the growth is unstable, unbalanced, uncoordinated, and unsustainable." Prime Minister Wen Jiabao, March 2007.

b. This entailed the progressive winding down of the system of non-tradable securities (which accounted for two-thirds of the total) held by public actors, following the transformation of State-owned enterprises into joint stock companies in the summer of 2005; the entry into force of the new legal framework applicable to the markets—the Company Law, Securities Law, and the Securities and Investment Fund Law—which notably govern listing procedures, lay down transparency requirements, rules on mergers and acquisitions, the supervision of private equity funds (1 January 2006); the ending of the freeze on initial public offerings (IPOs) and the arrival of large public-sector corporations onto the Hong Kong and Shanghai markets (in particular ICBC and Bank of China in the banking sector, in March 2006).

4.1 The measures currently implemented

Faced with a pronounced slowdown in the economy, the Chinese authorities responded in November 2008 with a massive stimulus plan combining an easing of credit conditions and a fiscal stimulus. The fiscal stimulus plan weighed in at CNY 4,000 billion over two years, representing 13.3% of annual GDP in 2008, of which $\frac{1}{4}$ percentage points of GDP were to be financed by the State and the remainder by other public actors, including local authorities, banks and public enterprises. This fiscal aspect of the plan (described in table 1) is centred primarily on infrastructure, support for consumption being treated as of secondary importance.

Table 1: Breakdown of the fiscal side of the Chinese stimulus plan

Type of spending	% points of annual GDP
Road, rail, airport and electricity network infrastructure	6.0%
Post-earthquake reconstruction	3.3%
Environmental and antipollution measures	1.2%
Funding for R&D and innovation	0.5%
Improving living conditions in rural areas	1.2%
Low-rent housing	0.9%
Healthcare and education	0.1%

Source: National Development and Reform Commission

Moreover, the Government has pledged to provide 90% of the population with primary healthcare between

(21) Particularly by opening up of public calls for tender or opening up to foreign investment.

(22) Notably by abolishing residence permits (hukou) and making welfare benefits portable from one province to another.

(23) The authorities are reluctant to do this for the time being, fearing that, in the light of Brazil's and India's experience, this could lead to the emergence and massive expansion of shantytowns.

(24) The abolition of export incentives and import restrictions will also be a step in the same direction.

(25) Employment Effects of Growth Rebalancing in China, Kai Guo and Papa N'Diaye, IMF *Working Paper*, 2009, no. 169.

(26) In particular, new infrastructures quickly become operational in China, and the Chinese economy's very strong growth could permit a reallocation of jobs with lower adjustment costs.

now and 2011. This healthcare plan is certainly a step in the right direction, being one of the desirable reforms needed in order to bring down households' precautionary savings. However, as it stands, **it is clearly insufficient and will fail to stimulate private consumption significantly:**

- even if the amounts involved are considerable, representing 2.8% of annual GDP over three years, **they are still insufficient relative to what is needed:** under this plan, Chinese healthcare spending (current expenditures + investment) would rise from 4.7 to 5.5% of GDP, roughly, on optimistic assumptions²⁷; that would put China on a par with India, but far behind the United Kingdom (8.1%) and still further behind the United States (15.4%);
- there is a dearth of healthcare infrastructures (hospitals, dispensaries, etc.) in the rural areas, so the plan will presumably seek to remedy this deficiency at least partially, which implies support for investment and not for private consumption²⁸.

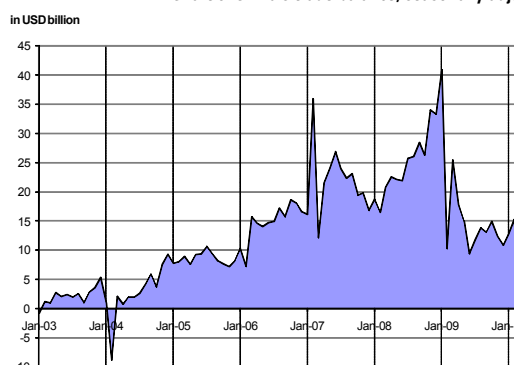
Finally, the monetary side of the stimulus plan—which is by far the most important—will almost certainly worsen the investment/consumption imbalance. Apart from the previously mentioned infrastructure projects, the historic expansion of bank lending in China in 2009 benefited the State enterprises chiefly, to enable them to carry out property investments and expand their manufacturing capacity.

4.2 The observed reduction in external imbalances during the crisis was only very limited and could prove to be shortlived

China's trade surplus (see Chart 7) narrowed between 2008 and 2009, from 6.6 to 4.0 percentage points of GDP, as the stimulus plan kicked in and global demand lost momentum.

Consequently, for the first time in many years, the contribution of foreign trade to growth was sharply negative, at -3.9 percentage points²⁹.

Chart 6: China's trade balance, seasonally adjusted



However, this external rebalancing is unlikely to be long lasting; first, as we have seen, the stimulus plan focuses mainly on investment, and China cannot durably redirect its growth model towards investment; and secondly, our estimates suggest that some 50% of the current rebalancing of China's current account is traceable to the short-term effects of the stimulus plan, and to the pronounced slowdown experience by OECD economies.

Benjamin DELOZIER, Cyril REBILLARD

(27) I.e., if the whole of the 2.8% of GDP represented recurring spending—which does not appear to be the case. With this plan, the budget allocated by the authorities to jobless urban residents and to farmworkers (representing 900 million beneficiaries) would only rise from CNY 80 to CNY 120 per inhabitant.

(28) Quite apart from the fact that, even after the necessary infrastructures have been built, another limiting factor would be the number of doctors available in the countryside.

(29) China's economy grew at a rate of 8.7% in 2009, coming after 9.6% in 2008.

Publisher:

Ministère de l'Économie,
de l'Industrie et de l'Emploi
Direction Générale du Trésor
139, rue de Bercy
75575 Paris CEDEX 12

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English translation:

Centre de traduction des
ministères économique
et financier

Layout:

Maryse DOS SANTOS
ISSN 1777-8050

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