Knowledge Leadership

China's Economic Rebalancing and Global Implications

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Rarely is a comment made on the global economy without referencing the global imbalance, and China's part in perpetuating it. At its simplest, the global imbalance is seen as a case of China producing/exporting too much and not consuming enough; and the US consuming too much and not saving enough. The typical narrative in this context is that China has become an export machine in order to support its breakneck pace of growth; with its competitiveness based on cheap labor, increasingly efficient infrastructure, and an under-valued currency. The label of "currency manipulator" is thrown in occasionally as the debate heats up. In fact, an export machine is not an inaccurate description. Twenty years ago, China accounted for a mere 2% of total world exports, and it rose to 11% in 2010. In that narrative, China's growth in exports puts the current accounts of the US and other big importers of Chinese goods in chronic deficits (and worse, destroying local jobs in these countries), while weak domestic consumption in China means growth has to continue to depend on more exports.

Regardless of how China is portrayed in the global imbalance debate, the fact of the matter is that in the past decade China has been reshaping the pattern of global trade, not just as an "export machine," but as a trading partner in terms of imports/exports of goods and services, investment and capital flows. Today, China is a key trading partner, sometimes the single most important one, for many of the world's most important economies. Table 1 shows China's rising importance as a trading partner (imports plus exports) between 2000 and 2009 in the global economy. The list in the table includes the richest economies in the world, the largest emerging markets, and the most important commodity producers, spanning across five continents. So what happens to China now matters a great deal more to practically everyone in the global economy.

This Global Insights report explains China's role in the global imbalance in terms of its domestic imbalance. While not denying the importance of currency exchange rates, I believe that neither China's success in exports nor its rise as a trading partner can be explained in terms of its under-valued currency. The "currency-centric view" would mean that the global imbalance cannot be resolved without the Chinese currency appreciating to a much higher market driven level.[1] Given the apparently snail's pace of the appreciation of the Chinese currency in recent years,[2] it would appear that the global imbalance is here to stay.[3]

Table 1. China's Rank as a Trading Partner

	China's Rank in 2000	China's Rank in 2009
US	4	2
Canada	4	2
Mexico	6	2
Japan	2	1
South Korea	3	1
Indonesia	5	2
Australia	3	1
India	10	1
Russia	6	1
South Africa	10	1
Brazil	10	2

Source: Estimated with IMF Direction of Trade Data

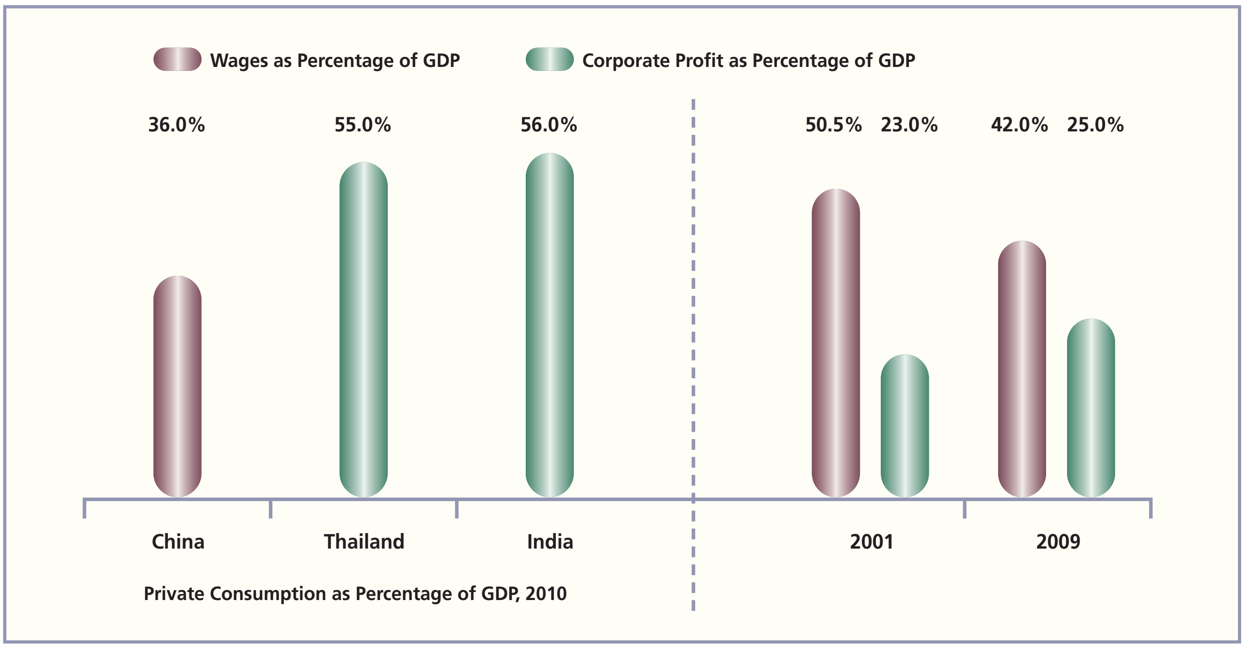
In contrast, I hold the view that China's role in the global imbalance is due primarily to its internal economic imbalance, mostly as a result of a series of developments in the past decade. From this perspective, China's under-valued currency has at best played a tangential role. The media hype on China as an export machine and being the factory of the world has the unintended consequence of focusing attention on the export side of the current account. Chinese exports are on track to continue to grow in the coming decade, and I have estimated that it could reach 18% of the world total by 2020, thereby matching the previous record set by the US in the 1950s during the height of America's global economic dominance. What will make all the difference is how fast China's imports will grow in relation to its exports. And this in turn is strongly affected by how China will rebalance itself domestically.

For example, China's current account surplus dropped from its peak of 11.3% of GDP in 2007 to 4.6% in 2010,[4] while the Chinese yuan's trade-weighted exchange rate rose by an average of only 2.2% a year over the same period.[5] What has brought about the reduction in China's surplus is a much faster growth of imports over exports. In 2010, for instance, China's imports grew by 39%, outpacing growth of exports of 31%. This trend has apparently accelerated in the first two months of this year, with imports growing by 36% versus growth of exports of 21%, year-on-year. When China's internal rebalance gains traction, imports will rise much faster in relation to exports, and consequently the global (external) imbalance will adjust as well. So the key is how China will deal with its internal imbalance. I believe China is now at the cusp of a profound structural shift in its economy, and in the coming years, coinciding with the 12th Five Year Plan, domestic private consumption will likely rise much faster than before. This will fundamentally change China's imports/exports dynamics, as well as domestic conditions such as where the majority of the Chinese people will live, and how they will work. But let's begin by taking a closer look of China's domestic economic imbalance.

China's Domestic Economic Imbalance

It is ironic that in a country run by a communist party, the share of national output accruing to the workers has shrunk over a period of super fast growth. But that is exactly what has been happening in China. As shown in Chart 1 (right side of the chart), the share of wages as a percentage of GDP in China fell from over 50% in 2001 to 42% in 2009. Over the same time period, however, corporate profit as a percentage of GDP rose from 23% to 29%. As a result, private consumption as a per-

Chart 1. China's Domestic Imbalance



Source: CEIC; Estimates with Data from China Statistics Yearbook, Various Years centage of GDP in China has also declined, and was estimated at 36% in 2010. This compares unfavorably with 55% in Thailand and 56% in India (left side of the chart). Weak wage and consumption growth are at the heart of China's domestic imbalance. How is it that in a country run by a communist party with socialism as its guiding ideology (albeit with "Chinese characteristics") the corporate sector is apparently outpacing the success of the working class?

Several key developments in the last decade converged to create China's internal imbalance. The first is the state-owned enterprise (SOE) reform that created a new breed of corporate players that were in a position to maximize monopoly profit, while benefiting from declining real labor costs (labor productivity rising faster than wages). The second is China's rapid pace of urbanization which has been luring migrant workers to urban areas, swelling the supply of the urban labor force. These two key developments then interacted with some of the unintended consequences of the One Child Policy to keep household savings high, thereby suppressing private consumption.

In 2009, three Chinese companies, all SOEs, were listed in the top ten of the Fortune Global 500. They were: Sinopec in seventh place, State Grid in eighth, and China National Petroleum in tenth. In fact, there were 44 Chinese companies, the vast majority of them SOEs, in the Fortune Global 500 that year.[6] A decade earlier, the notion of any companies from mainland China being ranked in the top 500 of the world could not be imagined. The fact is that by the end of the 1990s, the state-owned industrial sector in China was basically bankrupt. The non-performing loans of the banking sector in China were over 3.5 trillion yuan in 1999, about 18% of all loans outstanding.[7] Virtually all of the bad loans were lent to SOEs. In the beginning of the 1990s, SOEs were the beneficiaries of a lending binge by the banks that was made in the wake of the famous "southern tour" of Deng Xiaoping. By the end of that decade all that SOEs had to show were mountains of bad loans.

By then, Zhu Rongji, the prime minister, was preparing China for WTO membership. To do so, he launched a wide-ranging economic reform program, part of which was SOE reform. Different options were mooted. Just prior to the 1997 Asian financial crisis, the Korean *chaebols* were intensely studied, and at one time it was thought a suitable model for China's SOEs to emulate. Post-1997, with many chaebols going bust, that option was quickly dismissed. A more hard-nosed alternative argued for wholesale privatization of the SOEs, but it was quickly recognized that genuine privatization would mean letting the market decide the fate of the SOEs, and giving up state control of the massive industrial sector, hence government's leverage over a significant portion of employment and investment in the economy.

Instead, Zhu opted to shut down a portion of the SOEs that were clearly beyond salvage, and consolidated the rest to make them viable. And an important step in the process was to order the banks to forgive all the SOE bad loans. This meant, of course, leaving the banks on the spot. To save the banks, Asset Management Companies (AMCs) were created to take over the bad loans, allowing the banks to be recapitalized. The AMCs were then tasked with recovering as much of the loans as they could from the defaulters, the SOEs.

The cleaned up and consolidated SOEs then started to perform extraordinarily well after China's entrance to WTO. Foreign direct investment continued to rise (it actually started accelerating prior to China's WTO membership), exports boomed, and the economy expanded; consequently SOEs rose like ships being lifted in a rising tide. Many SOEs also operated in either strictly protected or in quasi monopolistic sectors such as telecom, transportation, energy, and assorted heavy industries, thereby enjoying monopoly rent; which was then made even more lucrative by the commodity upswing cycle that started mid-decade. Meantime, they were not required to pay dividends to their shareholders, the government. For SOEs involved in resource extraction, they did not pay royalties to the owner of the resource either, which once again, was the government. The SOEs continued to enjoy preferential access to bank lending whenever they needed new funds, and at exceptionally low interest rates. The net result was, not surprisingly, extraordinary SOE profits.

One of the factors driving up corporate profits overall, not just for SOEs, has been the labor market dynamics in that decade. Urbanization accelerated, averaging some 20 million people in urban areas a year. Rapid growth was evident across the entire spectrum of urban areas, from megacities like Shanghai, Beijing and Shenzhen, and second tier cities like Wuhan, Xian, Nanjing, all the way down to small third-tier cities (more on urbanization later). To put things in perspective, in 1981 it is estimated that only 18% of China's population lived in urban areas. By 2010, it was close to 50%.[8]

Urban expansion of such a scale drew in an army of migrant workers from the farms. Migrant workers are not the same as rural-urban migrants, at least not in the beginning (though many ended up becoming residents of the cities in which they have been working, only after they managed to acquire the residency permit, the *hukou*). Many migrant workers work only part of the year in cities, and spend the rest of the time, back on the farm to help with planting and harvest. Like all farmers, planting and harvesting are the busy times, and it is the in-between period that they are underemployed, hence their migratory pattern to seek paid work in cities. Many migrant workers are recruited into the construction sector, powering the massive infrastructure rollout across the country. Many others, especially young women, work in light manufacturing in the southern and the eastern coastal region, producing exports that give China the reputation of being the factory of the world.

It is this army of migrant workers, variously estimated to be between 100 to 120 million, that has had the net effect of keeping wages low in relation to growth of productivity and corporate profit. Due to their part-time status, their wages proximate the equilibrium price of labor, determined solely by demand and supply at any given time and, until very recently, not protected by any minimum wage regulation and which did not obligate the employers to cover their healthcare, pension, and other related social benefits. In any sectors where migrant workers can be employed on a regular basis, which include construction and light manufacturing, migrant workers have made a huge contribution, while receiving the absolute minimum in return.

High corporate profits and low wages mean, however, low private consumption by households. Consumption is kept even lower due to the relatively high household savings rate. Chinese urban households tend to save around 20% of their disposable income,[9] compared with the 10 to 12% average seen in many other Asian markets.[10] This higher household savings is due to several unique factors in China. The first is the One Child policy, which motivates parents to save as much as they can to make sure that they can afford the best healthcare money can buy should their single child get sick and the best private education that money can buy to ensure the child's future success. For the young singles being able to afford a private condominium is now a prerequisite for being able to marry, hence the pressure to save for a down payment. All these contribute to China's higher household savings and subdued consumption.

It is common to hear in media commentaries that Chinese households save too much and do not spend enough. It follows that the remedy for rebalancing the global economy is to encourage the Chinese to spend more. The reality is that given what they earn, and what they have to put aside for the proverbial rainy days, Chinese consumers are actually very enthusiastic spenders. They more or less spend as much as they can, and cannot be accused of causing the global imbalance because of their supposedly extraordinary frugality. They certainly play a role in the internal imbalance of the Chinese economy, but it is more the role of victims of the internal imbalance than its cause. To rebalance the Chinese economy, wages will have to grow much faster in relation to productivity and corporate profit, and households will have to feel that they need to save less even as their income is rising faster than before. These may well happen in the coming years.

The Dragon's Dance: The 12th Five Year Plan

It would be naïve to suggest that the leadership in Beijing is not aware of China's domestic imbalance and the challenges associated with it. The question is what are they going to do about it? The answer, at least in part, can be gleaned from the broad outline of the 12th Five Year Plan, which was approved by the People's Congress on March 14, and is due to take effect this year. While many of the specifics are yet to be spelled out,[11] the Plan does aim to create a new economic model that could rebalance the Chinese economy. It recognizes that in spite of having survived the 2008/09 global financial crisis, the economy today suffers from problems of unbalanced, uncoordinated, and unsustainable developments. The key solution, which is seen as the prime driver of change, is to continue and accelerate the pace of urbanization. Getting people to move into towns and cities at a pace even faster than that of the past decade would, at one stroke, deal with the challenges of rural under-employment, over-investment in the industrial sector, weak household consumption, income disparity, and chronic current account surpluses. It is no surprise that Vice Premier Li Keqiang, has consistently focused on how to get urbanization right as his theme whenever he spoke to the press and in public forums in the past year.

Getting urbanization right in China could indeed address many of the country's major problems of economic development overall, and the internal imbalance in specific. A proper discussion of urbanization in China will, however, require a great deal more space than a section of a single report of this kind. Instead, the focus here is on how urbanization could address the internal economic imbalance that has been built up in the past decade as described earlier.

First and foremost is the difference in propensity to consume, especially in discretionary spending, between rural and urban households. Adjusted for income, an urban household tends to spend more on consumption than a rural household.[12] Clearly in urban areas the consumer lifestyle is able to spread faster and wider, with the proverbial "word of mouth" and "peer persuasion" being more powerful in propagating new consumer market trends. On the supply side, the high concentration of consumers in urban centers facilitates the development of shopping malls and markets, offering consumers choices that are simply not available in rural markets. Shopping, socializing, dining out, and entertainment tend to blend seamlessly into an urban lifestyle, driving up consumer spending.

Incomes are also higher in urban areas. Even for migrant workers, what they earn in cities is still higher than what they would have earned had they stayed on the farm. Their pay looks low only when compared with regular urban incomes. And there is no mystery as to why urban wages are higher. Better urban infrastructure means workers have better tools to work with, and hence, more productive.[13] Urban economies also benefit from more powerful economies of scale and economies of scope, which offer more opportunities for specialization, thereby boosting urban productivity. As a result, urban wages tend to increase a lot faster than rural ones; and that is exactly what has been happening in China in the last decade. With higher urban wages, the stronger propensity to consume observed in urban households is then amplified by their larger household wallet.

The urban economy is also more conducive for faster growth in the service sector in China, which has been a laggard compared with the industrial sector. With rising incomes, urban households' marginal spending shifts quickly from goods to services, creating more potential for the service sector to expand and create more jobs. It has been estimated that with the same increase in demand, the domestic service sector tends to create up to 45% more jobs than the export sector.[14] Again, there is no mystery as to why this is so. The multiplier effect is simply higher in the urban service sector compared with exports. An increase in service demand quickly ripples across the urban service economy to generate new demand for other services, which has a positive 'knock-on' effect on yet other services and so on. Think of the opening of an upscale restaurant in Shanghai. Architects and designers are likely involved in creating the ambience commensurate with the prices on the menu. Advertising agencies are needed to promote it to targeted customers. For branding purposes, the restaurant may decide to sponsor a show in a gallery with a gala reception, engaging event management and public relations specialists. All these generate new activities in a wide range of professional services, apart from jobs created in the actual operations of the restaurant itself. In contrast, an increase in demand in exports is more likely to generate a one-off increase in production activities, especially if the production is in assembling manufacturing with a high level of imported components. Urbanization and the service sector are therefore mutually reinforcing, with the net effects of raising household incomes and boosting consumption.

As suggested earlier, an important factor in raising household consumption lies in reducing their savings. Chinese households' precautionary savings are high because of poor public provisions of health care and education services as well as patchy coverage of retirement pensions. It happens that it is more cost-effective to upgrade health and education services in urban rather than in rural areas, due to urban population density and associated economies of scale. Therefore for every extra yuan spent on health and education by the government, it has a greater impact in urban areas when it comes to reducing households' precautionary savings and raising their consumption. And increasing investment in public health and education is what the government intends to do in the context of accelerating urbanization in the 12th Five Year Plan.

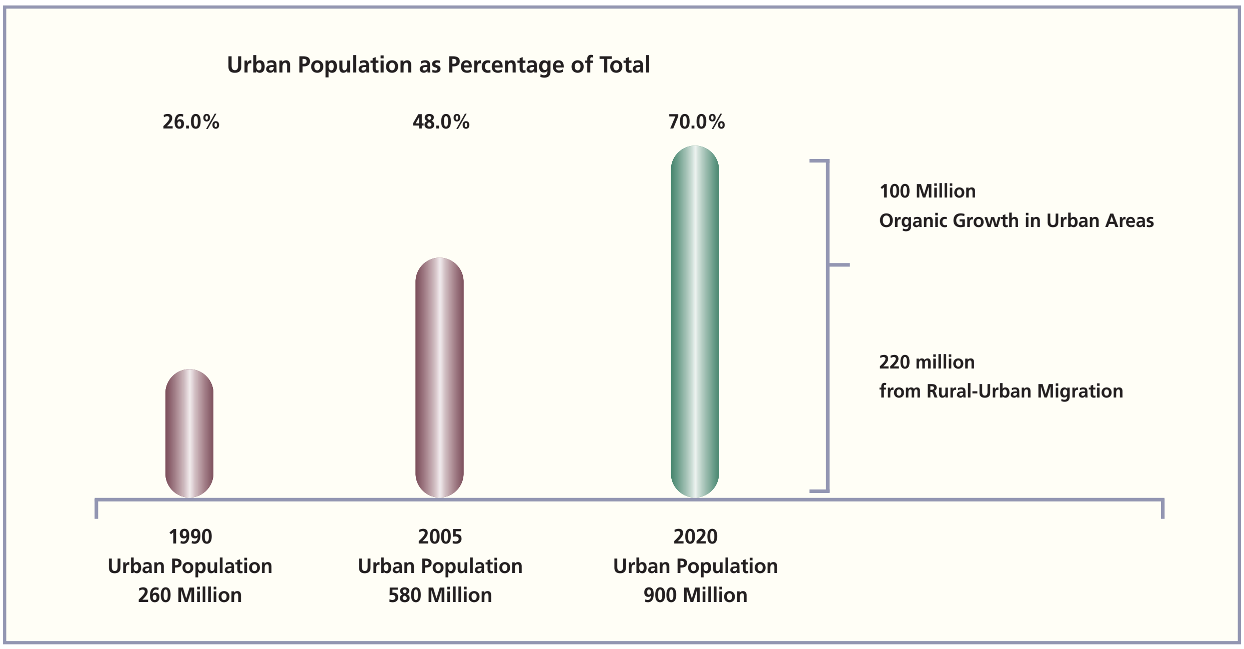
Finally, faster urbanization also has the added benefit of reducing income disparity. Assuming the average income levels of urban and rural China remain unchanged for the foreseeable future, the fact that the urban population will expand while the rural population will shrink at a faster rate in the next five years would improve income distribution overall. Shifting workers from rural to urban areas simply means more workers are earning higher urban wages.

Chart 2 illustrates the projection of China's urbanization to 2020. It is expected that by the end of this decade, some 70% of China's population will be living in urban areas, up from 48% in 2005. This implies an addition of 320 million to China's urban population. Some 100 million of this increase will come from "organic growth," consisting of population growth from today's urban population, and conversion of rural areas (and the population) into urban areas in the coming years. Another 220 million will come from rural-urban migration.

In addition to the positive multifaceted impacts of urbanization, a number of regulatory changes in the governance of the SOEs will also help China's internal rebalancing. SOEs are now required to pay dividends, and SOEs in resource extraction are also required to pay royalties. These measures will reduce SOE profit while boosting government revenues. The new revenues generated will in turn allow the government to invest more in expanding the coverage of the social safety nets and in improving service delivery. It is expected that government spending on health and education services will go up significantly during the 12th Five Year Plan, with coverage expanding to include migrant workers as well. A national pension plan that is universal and portable is also being planned for implementation.

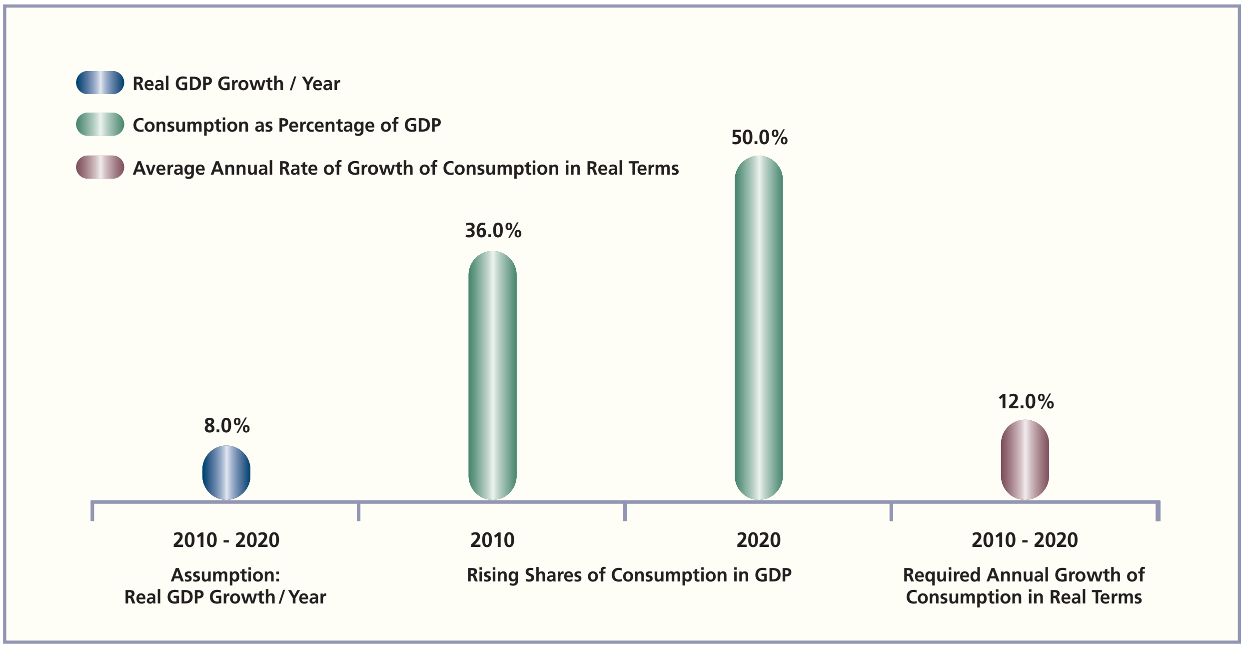
It remains to be seen, however, the extent to which the intended objectives of the Plan will be implemented, and once implemented, the extent to which they are effectively enforced. Even if the measures outlined above are only partially successful, they could still go a

Chart 2. China's Urban Future



Source: MasterCard Asia/Pacific

Chart 3. Faster Consumption Growth Needed in the Future



long way in rebalancing China's domestic economy. Chart 3 summarizes a simple simulation of the kind of progress that can be achieved with a modest level of success in policy implementation. Assuming that real GDP growth rate will average 8% a year between 2010 and 2020, the GDP share of private consumption could rise from the current 36% to 50% if private consumption can grow in real terms by 12% a year. Given the average real growth rate of private consumption in the past decade is around 8%, this means private consumption will have to grow by about one-third faster in the future. Can this be achieved?

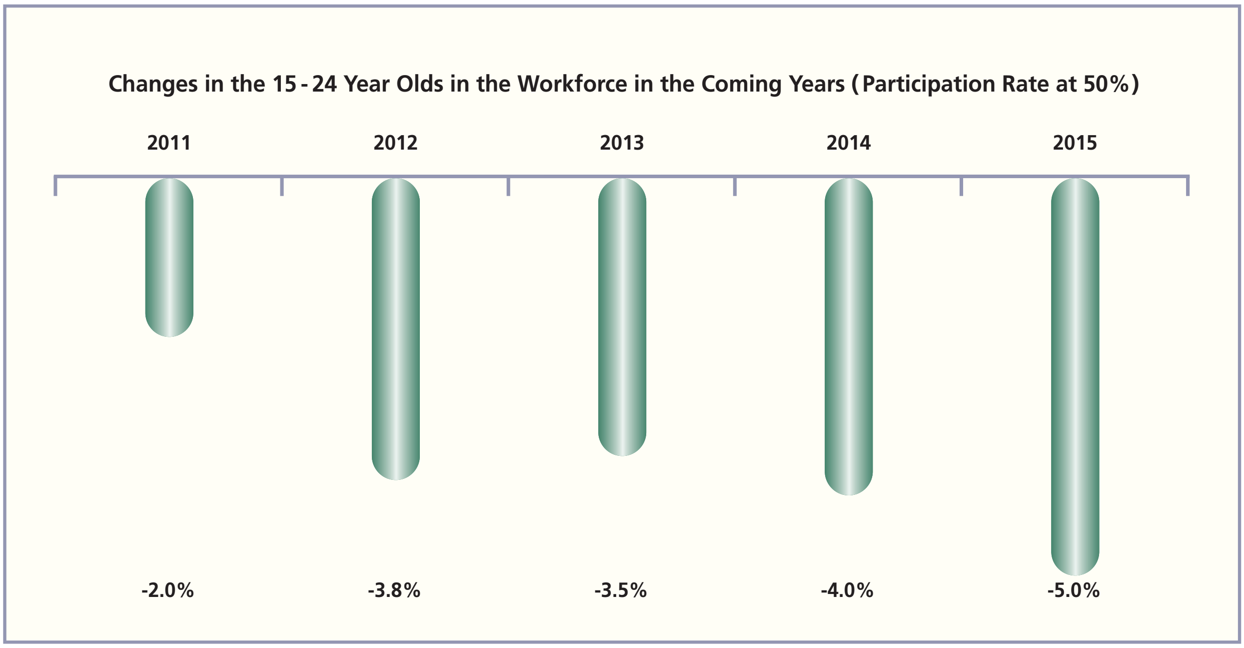
If household income growth begins to match overall real GDP growth in the coming years, this means an average growth rate of 8% a year. Using a conservative assumption of household consumption growing at the same pace as household income, then income-induced growth of household consumption will be 8% a year as well. If a household's precautionary savings rate is reduced due to better public health and education services and pension coverage, to around 12% from the current 20%, then it would add another 3% growth to household consumption. So the 12% increase per year in private household consumption is possible under the right circumstances.

China's Demographic Shift

Apart from the potential impacts arising from policy measures related to the 12th Five Year Plan, China's demographic dynamics are giving the rebalancing a powerful push. In the past three decades, the One Child policy has slowed population growth significantly, and, in the process, accelerated population aging. The average age of a population rises when there are more older people, as a result of rising life expectancy, and fewer young people. The result is a powerful demographic shift.

China's school enrollment rate is very high, with primary school enrollment approaching 100% so changes in student enrollment numbers in primary and secondary schools, which are good indicators of the overall number of young children and teenagers. According to data from the Ministry of Education, primary school enrollment peaked in 1998, and by 2008 it was 25% lower than the peak level. Secondary school enrollment peaked in 2003, and has since been declining, albeit at a much slower rate. The fact that peak secondary school enrollment lags peak primary school enrollment by some five years also makes sense. At their respective peak years, these primary and secondary students would have been born in the second half of the 1980s, when the One Child policy, though introduced earlier,

Chart 4. China's Demographic Tectonic Shift



Source: Estimated with Data from the US Census Bureau and Chinese Academy of Social Sciences

began to be more rigorously enforced, and started to take full effect. These declining enrollment trends are the telling leading indicators of how the supply of young workers will shrink as a result of China's demographic shift.

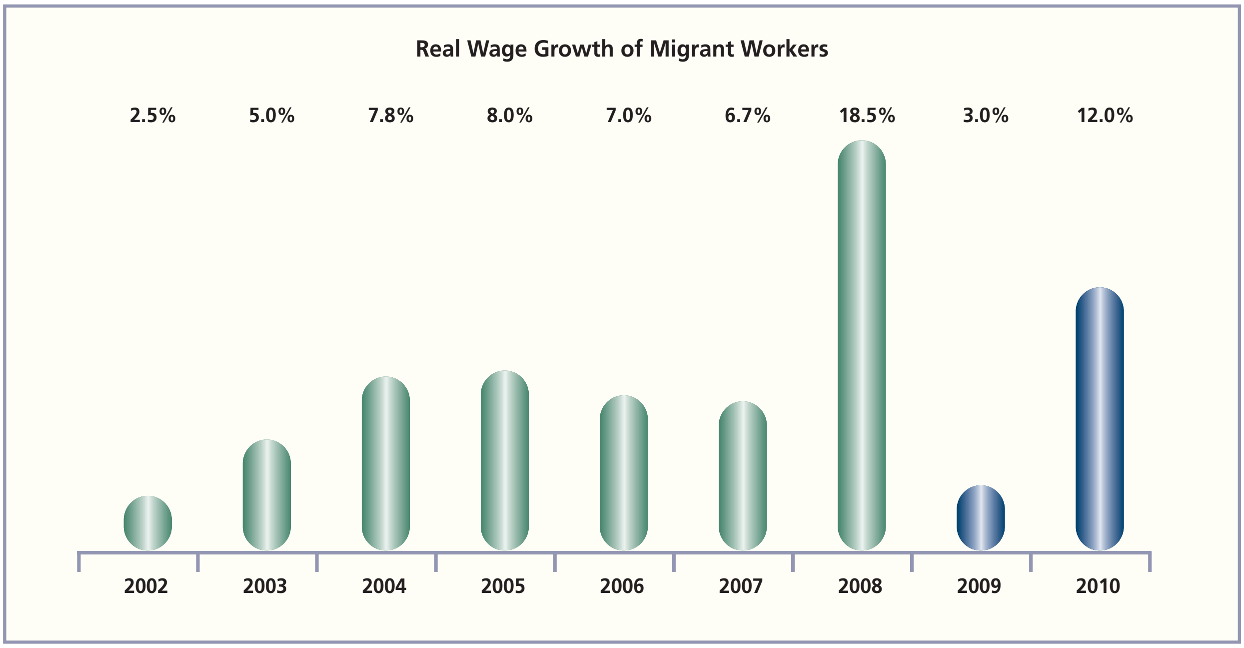
Expanded opportunities for higher education further aggravate the trend of a shrinking supply of young workers. More young people attending tertiary education means a lower labor force participation rate in their age groups. Chart 4 shows a projection of changes in the numbers of 15-24 year olds in China that will be available for the labor force in the next few years, assuming a participation rate of 50%, down from the 65-70% level in previous decades. The projection shows unmistakably a shrinking supply of young workers in the labor force. A 50% participation rate means that half of the 20-24 year olds will be studying instead of working in the future, up from around 25-30% a decade ago, thus squeezing the dwindling supply further.

This demographic shift, in combination with the wide ranging impacts of faster urbanization, will push wages to rise faster than before, thus systematically changing the industrial structure of China itself. A good indicator is migrant workers' wages which, as argued earlier, proximate the equilibrium price of labor as dictated by the raw supply and demand conditions. Chart 5 shows growth of migrant worker wages in real terms from 2002 to 2008 as estimated by the Chinese Academy of Social Sciences. It basically rose continuously since 2002, and it spiked in 2008 to 18.5%. In 2009, in spite of the near collapse of China's exports due to the global financial crisis, migrant workers' wages nevertheless grew in real terms by 3%, followed by a strong rebound of an estimated 12% growth in 2010. These growth rates clearly reflect a gradual tightening of labor supply, puncturing the myth of the "inexhaustible supply of Chinese labor." As new policy measures associated with the 12th Five Year Plan begin to kick in this year, wages in general not just for migrant workers, will begin to rise faster than in the past. This makes the prospects of wage growth keeping pace with real GDP growth, a pre-condition for domestic rebalancing as argued above, much more likely.

Keeping Step with the Dragon's Dance: Global Implications

China's domestic rebalancing will have far-reaching global implications. The most obvious is that China's current account surplus will shrink over time. Make no mistake, China will continue to be a strong exporter in

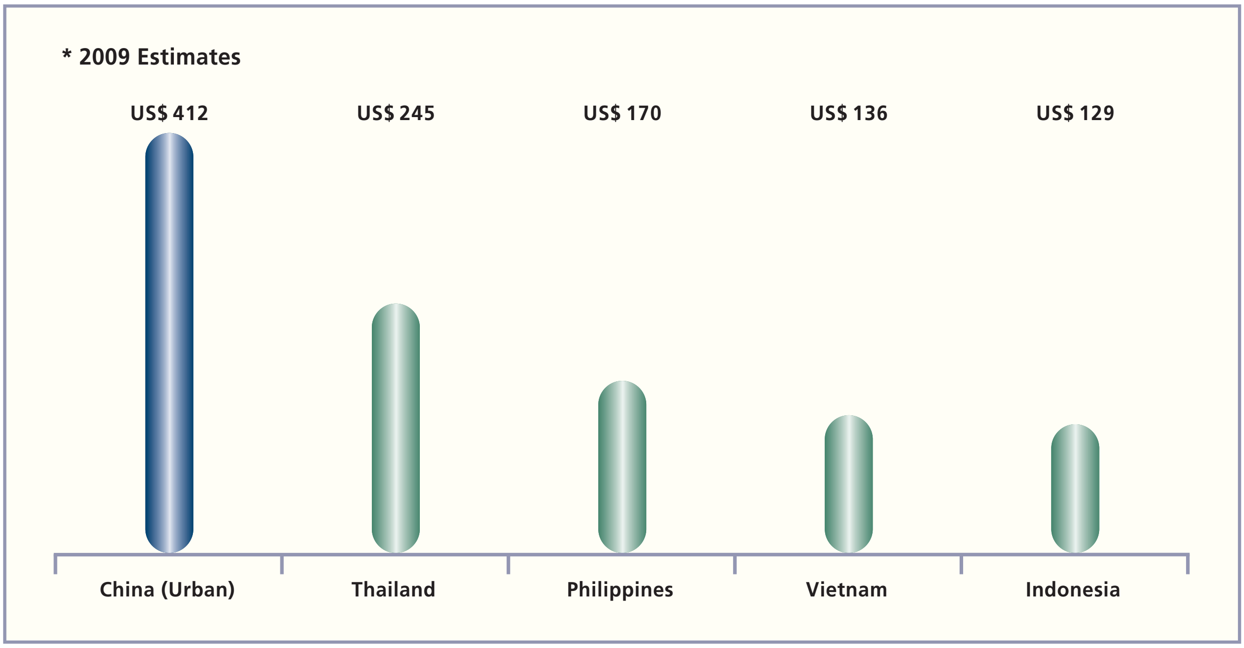
Chart 5. Higher Wage Growth in the Future



Source: Chinese Academy of Social Sciences

the foreseeable future,[15] and its current account will likely continue to chalk up annual surpluses. However, domestic rebalancing could reduce the surplus to around 1% - 2% of GDP from its previous peak of over 10%, thereby reducing the global imbalance. With faster urbanization, rising consumption, and more jobs being created in the service sector; China's import composition will also change. While infrastructure investment will continue to be a key driver of growth in China, thus necessitating continuing imports of commodities like iron ore and copper, a more service-intensive economy simply means a less resource-intensive

Chart 6. Monthly Manufacturing Wages Compared



Source: MasterCard Asia/Pacific

one. China will gradually import more to meet household consumption needs, and less industrial components and raw materials to feed the manufacturing sector. As a "swing" buyer of many key commodities in the world market, China's reduced appetite for resources, however marginal, could have significant impacts on their global demand/supply dynamics.

Part of the change in China's industrial structure is that low value-added assembly manufacturing will become less viable as wages rise. It is my estimate that monthly manufacturing wages in China today are already higher than many neighboring countries. Chart 6 compares monthly manufacturing in 2009 between China and Thailand, Philippines, Vietnam and Indonesia. The wage gap between China and these Southeast Asian countries are set to widen even further in the future.

China today has the world's largest manufacturing labor force, which has been estimated to be around 165 million. If 1% of China's manufacturing capacity is to relocate to the four countries of Thailand, Philippines, Vietnam and Indonesia, adjusted for productivity, this would entail an increase in manufacturing employment of these four countries by up to 15%. So quite apart from shrinking the current account surpluses and altering global demand/supply dynamics in commodities, China's domestic rebalancing would also be a source of new growth in many countries in Asia and beyond.

1. How exactly is a market driven exchange rate determined is itself fiercely debated, however. There are three key methodological approaches: a fundamental equilibrium exchange rate (the so called FEER), a purchasing power parity based exchange rate, and a unit labor cost productivity-based exchange rate (the so called REER). While all three approaches agree that the Chinese currency is undervalued, they differ hugely on the degrees of under-valuation, ranging from 12% to 50%.

2. The Chinese yuan has been appreciating against the US dollar in nominal terms in the past five years at around 5% a year.

3. It is worth pointing out even if the Chinese yuan were to appreciate at an improbable pace of, say, 50%, in the next year or so; there is still no guarantee that the US current account deficits will be eliminated. In the two years following the 1985 Plaza Accords, the exchange rate of Japanese yen doubled against the US dollar, and yet the US current account deficits against Japan persisted.

4. PBoC data.

5. Bank of International Settlement data.

6. Fortune, July 26, 2010.

7. PBoC data.

8. China Statistical Yearbooks, various years.

9. The regularly reported figures of 40 to 50% of GDP saved in China refer to total national savings, the bulk of which is actually savings by the corporate sector.

10. See the MasterCard MasterIndex of Consumer Confidence, Spending and Savings Priorities. www.masterintelligence.com

11. A great deal of policy details will be developed by the two dozen or so ministries and local governments.

12. Recent survey evidence of Chinese urban households' higher propensity to consume is observed in MasterCard's Insights Report Government Stimulus and Consumer Response in China— Implications for Future Growth, 3Q, 2009.

13. In economic terms, this means a less skewed labor-capital ratio, and in the context of a developing economy with low capital stock per capita, marginal returns on capital tend to be higher than marginal returns on labor.

14. Derived from estimates by Feenstra, R.C. and Shang-Jin Wei, 2009, China's Growing Role in World Trade, National Bureau of Economic Research Working Paper.

15. In the coming decade, China's export composition will shift increasingly to capital and knowledge intensive goods as opposed to labor intensive light manufacturing.

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