RCIF
Research Center for International Finance

Policy Brief No. 2011.058

Sep.19 2011
www.rcif.org.cn

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The Transition of China's Development Model

From 1978 to 2010, China had achieved a continuous high economic growth under controllable inflation pressure. During the 33 years, the average GDP growth is 10.0%, and the average CPI growth is 5.4%.[1] The sustained economic growth enabled China to become the second largest economy throughout the world in 2010. However, the success in the past could not verify the success in the future naturally. The old development model of China is more and more unsustainable under current circumstances, especially after the burst of global financial crisis. If Chinese economy could not 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 the following: The first and second parts analyze 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.

[1] The data comes from CEIC.

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]

Chinese government has always put the industrialization into the top of priorities on its development agenda. To stimulate the investment, Chinese government has been pushing down various domestic commodity prices, including energy prices and environmental costs. Moreover, Chinese government has been keeping an artificially low interest rate environment through the interest rate regulations. Both the low commodity prices and the 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 Chinese government adopted a way of strong investment combined with weak domestic consumption, Chinese economy had to rely on the export to absorb the excess capacities. To promote the growth of export, 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 of years, the dependency ratio in China is very low. The demographic surplus enjoyed by China means a nearly infinite labor supply, especially for unskilled labors 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

[2] Ibid.

negative byproducts. As the 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 twenty years (1989 to 2009).[3] An economy of high investment ratio and low private consumption ratio tend 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 could not 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 to 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 with a capital account deficit (such as Japan and Germany), or a current account deficit accompanying with 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's ridiculous for China (a developing country) to lend such a huge amount of money to very rich countries such as America and Euro Zone. Moreover, the value of China's foreign exchange reserve will suffer huge loss if the global inflation goes up or if USD depreciates sharply.

Thirdly, there is a significant industry imbalance in China. Generally speaking, China's manufacture 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 induct more resources to

[3] Ibid.

flow into tradable sector, thus hamper the development of non-tradable sector. Another factor is the state-owned enterprises (SOE)'s monopoly in many high-profitable service sectors such as telecommunication, railway, finance, medical care, education, etc. The state monopoly in many service sectors is also a key factor why China has strong SOEs but weak small and medium sized enterprises.

Fourthly, although Chinese government's fiscal position is better than many developed countries such as United States and Japan, Chinese economic growth relies heavily on loose monetary policy. As a result of 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 high monetized. If Chinese government could not 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?

After the burst of U.S. subprime mortgage crisis and European sovereign credit crisis, the external environment of China has been changing dramatically. Chinese government found suddenly 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 global financial crisis. The vast appetite of U.S. consumers for global goods before the crisis had been proved to be a bubble. After the crisis, the U.S. households entered a stage of deleveraging, which meant that they would cut the liabilities and decrease consumption. The deepening of European debt crisis has already resulted in a slower economic growth for Euro zone countries. The shrinkage of external demand will definitely impact China's export growth. If China's private consumption could not rise accordingly to absorb the capacity of manufacture 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 U.S. subprime mortgage crisis, to stimulate the economic growth, Chinese government adopted a fiscal rescue package amounted 4 trillion RMB, most of which were invested on infrastructures such as high speed railways, express ways and airports. Lots of evidences show that there has been already a bubble in the infrastructure construction in the past several years. If the new infrastructures could not be utilized enough to cover the principal and interest of relating loans in the near future, the investment vehicles sponsored by local government which did the infrastructure investment will go 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 began to face the bottleneck of energies and commodities. When China is still a small economy, the demand from China will not cause large fluctuations of global energy and commodity prices. But as China becomes one of the largest economies around the world, the China's demand become one of the major forces pushing up and down global commodity prices. When 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. A proof is that China's term of trade has been deteriorating in the past decade.

China's demographic surplus is vanishing. As the result of birth control policy which has been adopted over 30 years, 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 labors will decrease gradually in the future. On the other hand, the transfer of rural labors to urban areas will complete in the next ten or twenty years. The change of demographic structures will lead to the rise of labor cost, which will weaken the price competitiveness of Chinese manufactures. If not managed well, the sustained rise of labor 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 USD's dramatic depreciation in the mid-term. 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 USD to 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, Chinese government will suffer a great capital loss if USD depreciated 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 global financial crisis, Chinese government has adopted an over loose monetary policy. The RMB bank lending reached 9.6 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, Chinese government should raise interest rate 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 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.

First, Chinese government should promote the reform on the income distribution inequality in 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, 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 household (e.g. by injecting the money into social security accounts).

Another level is the income distribution inside the household sector. 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.

Second, 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 household will be very glad to consume more goods and services.

Third, the domestic factor prices should be liberalized as soon as possible, which include utility prices, commodity prices, environmental costs, exchange rate and interest rate. The prices of China's manufactures could reflect its real comparative advantages after all the factor prices are fully liberalized. The liberalization 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 Chinese government to liberalize 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 liberalization 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 liberalization will result in the shrinkage of interest rate spread, therefore hurting the profit margins of commercial banks.

Fourth, 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 manufacture goods is relatively enough, but the household's consumption of service is significantly low 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 Chinese economic growth more sustainable and to let Chinese household and corporate enjoy more growth surplus, 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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