China’s growth over the past three decades has been the world’s most heralded development story, as China became a global economic power even as it lifted hundreds of millions out of extreme poverty. The strategy enabling this marvel was based on a tried-and-true formula in Asia – attracting foreign investment to create a competitive export sector, shifting workers out of low-productivity agriculture into manufacturing and investing heavily in infrastructure to support industrialization. Yet while the success of this strategy is undeniable, it is not invincible. The slowdown that China has experienced in the past two years cannot be written off as a mere bump in the road. For the past decade, it has become increasingly clear that China must alter its growth model to sustain its headlong quest for affluence.
The necessity has not gone unnoticed by China’s top leaders. As far back as 2007, Wen Jiabao, then the premier, characterized the country’s economic model as “uncoordinated, unsteady, imbalanced and unsustainable.” More specifically, policymakers and independent analysts agree that capital-intensive growth has not generated sufficient gains in household consumption. The economic pie has been growing rapidly. But the slice going to households has been shrinking, increasing income inequality and undermining social cohesion. An even greater concern is that distortions created by the focus on the supply side may lead to a wrenching correction. China invests a larger share of its GDP than any other major economy, making it especially vulnerable to asset bubbles as well as to the ongoing waste of capital.

To put its economy on a more sustainable path, China needs to rebalance the sources of economic growth. This means a shift away from the policies that created the economic winners of the past decade – manufacturers and property developers – toward policies that favor households and the service sector. Chinese economic policymakers will have to reduce government controls and market intervention and become more comfortable with allowing supply and demand to guide ever-larger segments of the economy. The challenge is daunting, but the experience of China’s neighbors who have taken such steps may serve as a guide.

**The Price of Capital**

In a free-market economy, the interest rate reflects the “price” that equates the supply of savings with the demand for investment. But to keep China’s banks profitable and avoid a recurrence of the nonperforming loan crisis of the late 1990s, the central bank (the People’s Bank of China) sets a ceiling on deposit rates and a floor on lending rates. In effect, the regulators give the banks a guaranteed profit spread.

Equally important, that ceiling on deposit rates has been kept artificially low; real deposit rates (the posted rate minus the rate of inflation) have generally been negative since 2003. This ensures the banks a cheap source of funds, and it discourages hot-money inflows from foreigners buying Chinese renminbi in expectation of profit as the currency appreciates. But it also pinches consumption, as household must struggle that much harder to build nest eggs.

Reforms that let the market determine interest rates would lead to both higher earnings for savers and higher costs for borrowers. That would reduce China’s extraordinarily high rate of investment. Meanwhile, higher deposit rates would promote consumption through three distinct channels. First, higher rates translate directly into more interest income for households. Second, they would probably lower total personal savings because households wouldn’t need to set aside as much for retirement, medical emergencies

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and other non-day-to-day events. Third, higher capital costs would lead businesses to use less capital and more labor, increasing the share of income going to workers and leading ultimately to more consumption.

Progress on interest-rate liberalization, though, has been uneven. While the ceiling on lending rates has been lifted, deposit rates remain heavily controlled. A move to increase the flexibility around benchmark rates, undertaken in June 2012, has yet to be followed by reforms to complete the task.

Policymakers do see the virtue of liberalization on the deposit side. But they are understandably concerned that higher capital costs would imperil the solvency of China’s corporate sector, which is collectively in debt to the banks to the tune of 100 percent of GDP. It makes sense, then, to liberalize deposit rates gradually over several years, presumably starting with medium- and long-term deposits and, later on, demand deposits. This would give both corporations and banks time to adapt to an environment with market-determined interest rates.

There may be a silver lining here for some debtors. Currently, many fast-growing private firms are forced to borrow at exorbitant rates from largely unregulated nonbank lenders, because banks have little incentive to serve them. Higher bank lending rates could actually lower borrowing costs for these firms as banks begin to find it profitable to bid for their patronage. But there is no getting around the prospect that higher capital costs for incumbent borrowers would push the least efficient out of business – a healthy process if done gradually, under well-defined bankruptcy rules.

The Price of Imports and Exports
China’s currency has been undervalued by varying degrees for the past decade as part of a strategy for promoting export-led growth. Allowing appreciation would, of course, reduce the growth of exports and increase the growth of imports, cutting China’s still-large global external surplus. It would also decrease the profitability of export-oriented manufacturing to the benefit of the service sector, which has lagged since 2002. And a more flexible renminbi would mean less intervention in the foreign-exchange market, a prerequisite for liberalizing domestic interest rates.

The renminbi has been pegged to the dollar since 1994. This policy worked well in the second half of the 1990s, when the dollar was appreciating against other major currencies. But beginning in 2001, the dollar began to depreciate with respect to other key currencies on a sustained basis. The Chinese authorities appeared not to have paid sufficient attention to this shift and did not adjust the renminbi’s peg. As a result, the renminbi began to depreciate steadily against the currencies of its other trading partners, and China’s trade surplus began to rise.

Moreover, even after Beijing modified the currency policy in mid-2005 under pressure from its trade partners, China’s external surpluses continued to expand. Given the degree to which the renminbi was undervalued in mid-2005, the initially sanctioned appreciation of just 2.1 percent and the modest pace of appreciation thereafter were not large enough to reverse the trend. Gradual appreciation halted again between the fall of 2008 and summer of 2010, when China reppegged its currency to the dollar because of concerns about the global financial crisis. All told, these interventions led to a sustained buildup of foreign-exchange reserves; by 2011, China held more than $3 trillion worth of foreign currency.

The pendulum has since begun to swing back. China’s current-account surplus in 2011 fell to 1.9 percent of GDP – down from its
10.1 percent peak in 2007. This decline followed in part from the 30 percent appreciation in the real effective exchange rate since June 2005, as the costs of manufacturing in China rose rapidly, in part from the ongoing economic weakness in China’s major export markets – particularly in crisis-bound Europe.

A shift toward market-determined exchange rates has merit on several grounds. For one thing, steady appreciation would need to continue for the currency to keep pace with productivity gains in the export sector and thereby prevent the emergence of another large external surplus. Appreciation would also reduce the profitability of export-oriented manufacturing, to the relative benefit of the service sector.

**The Price of Energy**

Price controls on electricity and liquid fuels function as implicit subsidies to China’s industrial sector, which consumes two-thirds of energy produced. This subsidy led to more capital-intensive growth at the expense of both total employment and growth in the service sector. Removing these subsidies would thus gradually increase the portion of GDP going to labor.

The degree of price distortion for gasoline and other liquid fuels is determined by the National Development and Reform Commission’s price-setting mechanism for crude oil. The refineries of the major state-owned oil companies operate at a loss when the price of crude oil is relatively high because they are not allowed to pass through the full cost of the raw material.

Price distortions are also present in the electricity sector. As with oil, when the price of coal spikes, the National Development and Reform Commission buffers the impact on electricity users at the expense of power producers and distributors.

This price squeeze on energy, combined with the financial repression of household savers and an undervalued currency, works to
the advantage of capital-intensive manufacturing – and thus to the relative disadvantage of the labor-intensive services. In the 1980s and 1990s, China’s service sector grew so rapidly that its share of GDP rose by an average of one percentage point per year, reaching 41.5 percent in 2002. But since 2003, service sector gains have slowed. Today, the share of services in GDP remains a full 10 percentage points lower than what is typical for other emerging market economies.

Who Gets What

The IMF estimates that China spends only 5.7 percent of its GDP on health, pensions and other forms of social protection – less than half the level typical for countries at similar levels of development. The government is committed to creating a more comprehensive social safety net. But protections financed by new fees and taxes on households (robbing Peter to pay Paul) wouldn’t necessarily boost consumption. Instead, a large share of the financing should come from the business side – in particular, by requiring state-owned enterprises to pay higher dividends and putting those funds towards pension and medical-insurance systems.

By the same token, addressing China’s high level of income inequality might well lower the household saving rate since households near the bottom of the income ladder generally save less than those near the top. Publication of official Gini coefficient statistics – a comprehensive measure of inequality – was delayed for almost a decade as China’s National Bureau of Statistics worked to harmonize income measurement between rural and urban areas. The new data, released this year, revealed that despite the nominal populism of the Hu Jintao/Wen Jiabao administration, income inequality remained high throughout the last decade. During this period, the Gini coefficient hovered between .47 and .49, implying that inequality in China is worse than in Russia and roughly on par with Nigeria and Mexico.

Given this level of inequality, improvements to the social safety net alone are unlikely to dramatically alter China’s savings rate, since high-income households groups responsible for the majority of household savings are not much affected by changes in the social safety net. Government policy should therefore concentrate on increasing the earnings of low-income households because, as noted above, this group is more likely to consume as its income rises.

Allowing markets to determine interest rates, energy costs and the currency-exchange rate would help increase workers’ share of GDP and thereby erode the enormous gains that have accrued to China’s wealthy capital owners in recent decades. A more balanced economic growth model should allow the
wage share of GDP to recover to levels more typical for emerging markets – around 55 percent. Other policies that could address inequality include increasing the progressivity of taxes and further reforms to the hukou household registration system, which shortchanges migrant workers seeking better lives in cities.

**GETTING FROM HERE TO THERE**

It is unlikely that any country can productively invest 40 percent of its GDP over a long period. Yet China’s investment has now exceeded this figure every year since 2003, peaking at 48 percent in 2011. A recent IMF study concluded that reducing investment’s share by 10 percentage points would bring China back in line with fundamentals. This level of investment would still be relatively high compared with the experience of other successful Asian economies; the rates in Japan, South Korea, Thailand and Taiwan peaked briefly at 39, 40, 43 and 39 percent, respectively, before declining. There are, however, good reasons to believe that, even after rebalancing, investment in China would remain comparatively high because of rapid urbanization.

Given that China’s large imbalances were built up over the course of a decade, it seems reasonable to expect that they could be unwound in a similar time frame without a major disruption to growth. To get from here to there, the growth of total investment would have to decline from an average of 14 percent annually to somewhere in the low single digits by the end of the decade. Imbalances within the overall trend of excessive investment also must be addressed. Specifically, residential real estate investment needs to decline as a share of investment in order to reduce the risk of a housing bubble. Urban housing investment reached 9.5 percent of GDP in 2012, a level that is far too high to be sustained. A more sustainable level for a rapidly urbanizing developing country like China would be something around 7 percent of GDP.

A reduction in investment growth would necessarily reduce GDP growth if no offsetting measures are taken to boost growth in consumption. Household consumption ticked up slightly in 2011. But to accelerate consumption growth in the face of slowing investment, policymakers would have to pursue the reforms outlined above.

What pace of consumption growth would be required to generate a sustainable 7.5 percent growth in GDP? Consumption expenditure (private and public) would have to accelerate, reaching 10 percent growth in the final years. For the period as a whole, consumption expenditure would have to grow an average of 9.7 percent annually in real terms – 2.2 percentage points more rapidly than real GDP growth.
At first glance, these targets appear unrealistic. There would inevitably be some disruption as China de-emphasized manufacturing in favor of services. But there is a misperception that the service sector is inferior to manufacturing in generating high-paying jobs. In fact, the opposite is true. For each unit of output, the service sector on average generates more employment than the industrial sector. And in 2011, average service sector wages were 27 percent higher than in manufacturing.

Another concern often raised by economists is that consumption wouldn’t grow fast enough to offset declining investment — that as investment slowed, consumption would be dragged down along with it. They argue that rebalancing could be achieved only at dramatically slower rates of GDP growth.

We disagree for a couple of reasons. First, consumption grew faster over the past decade than many economists believe: total consumption expenditure grew at an average of 8.5 percent annually since 2007, while household consumption grew by an average of 9.5 percent. This growth was achieved despite systemic policy distortions that have suppressed consumption, which should grow even faster if pro-consumption reforms were put in place.

Second, the example of Taiwan suggests that it is possible for consumption growth to outpace GDP even when GDP is growing rapidly. Taiwan, like the People’s Republic, experienced unbalanced growth during the early stages of its development, with the household consumption share of GDP steadily declining from 75 percent in the early 1950s to 47 percent in 1986. Rebalancing began in the mid- to late-1980s following enabling reforms. Over the subsequent two decades, the household-consumption share of GDP recovered to 60 percent.

The policies employed by Taiwan overlap with many of the policies we (and many others) have proposed for China. Taiwan reduced its intervention in the currency-exchange market in the late 1970s and the currency appreciated by 30 percent against the U.S. dollar during the mid-1980s. In the early-to-mid-1980s, the Taiwanese government promoted financial liberalization. In the same period, Taiwan put significant state-owned enterprise reform into effect and abandoned many restrictions on imports. The combined effect of these policies boosted Taiwan’s service sector, reduced the portion of GDP absorbed by the outsized industrial sector, and increased the share of the output going to consumption.
REBALANCING CHINA

THE POLITICAL ECONOMY OF CHANGE

A conventional wisdom is that political reform in China is a prerequisite to breaking the current deadlock on economic reform – that the power of vested interests has strangled change over the past decade. This argument has some validity, but is overstated.

In some policy areas, incumbent interests have successfully resisted reform. A clear example: the policies of state-owned enterprises toward the disposition of earnings. Despite intense pressure from the Ministry of Finance and the State Council, dividends paid by state-owned enterprises have increased only marginally since 2007, and what is paid is largely recycled back into the state sector. Other examples of resistance to policy reforms include the inclination of local governments to ignore central government restrictions on housing purchases and to resist reforms in land acquisition that are designed to increase compensation to peasants.

But note that the interest-group barrier argument is less clear-cut with respect to the key reforms for rebalancing.

There is a near-consensus among policymakers that reforms are imperative if both social stability and economic growth are to be sustained. China’s 12th Five-Year Plan (2011–15) included several core elements of rebalancing, including interest rate deregulation and liberalization of rules restricting international capital flows. And in September 2012, the People’s Bank of China and the China Banking Regulatory Commission released a financial reform plan calling for much the same approach.

The State Council addressed income inequality early this year, prescribing expanding the social safety net, using state-owned enterprise dividends to finance social programs and increasing the interest rate paid to household on bank savings.

Another reason to be optimistic is that rebalancing efforts can go a long way without cooperation from local governments. Start with the fact that, with approval from the State Council, the People’s Bank of China can liberalize interest rates, the exchange rate and the capital account. The dynamic of market competition would force all banks, even the large state-owned commercial banks, to begin offering competitive interest rates in order to hold on to deposits. This, in turn, would put upward pressure on lending rates, which, in turn, would tend to reduce the share of investment in GDP.

By the same token, a more market-oriented exchange-rate policy simply requires the People’s Bank of China to buy less foreign exchange and allow the currency to appreciate. More market-determined pricing for energy requires only that the National Development and Reform Commission allow fluctuating global market prices for oil and coal to be fully reflected in prices paid by final users of refined fuels and electricity.

The policy changes needed to increase social transfers and income redistribution would be more problematic in political terms. However, since they are immensely popular, they should still be manageable if the central leadership vigorously promotes them.

The slow pace of reform in the Hu Jintao/Wen Jiabao era stemmed from the top leadership’s weak commitment to restructuring. With the economy growing at breakneck speed, Beijing had little incentive to beat back interest-group opposition. But since the slowdown in 2012, rebalancing has taken on greater urgency. As rebalancing increasingly becomes seen as necessary to sustain growth – and by extension, the Communist Party’s political legitimacy – reforms will likely begin to be implemented with increased resolve.