



# Solving China's Rebalancing Puzzle

Market forces will do the trick “naturally”

Laborer carrying steel pipes at a market in central China's Hubei province.

*Jonathan Anderson*

**O**VER the past year, observers of the global economic scene have been treated to a rare spectacle, as a host of U.S. cabinet-level officials and their Chinese counterparts sat down in a much-touted series of meetings under the banner of the “U.S.-China Economic Dialogue.” The official program covers a long list of topics, including market access, intellectual property rights, U.S. export controls, and investment guarantees; however, it is safe to say that the real agenda is the ever-present U.S. bilateral trade deficit with China and the mainland’s burgeoning trade surplus with the world at large. In other words, the delegation is focused on the rebalancing of the Chinese economy, a topic that many China-watchers have latched onto in recent months.

But what does “rebalancing” really mean, and how can it be achieved? This is by no means a simple question because China is one of the most unique and puzzling economies in the world—and, as it turns out, conventional wisdom on the topic may be misguided.

## What is going on?

Here is the fundamental problem. On the one hand, over the past three years, China has seen a rapidly rising trade and current account surplus—about 10 percent of GDP in the first half of 2007, up from 3 percent in 2004 and about 2 percent in 2000–03. On the other hand, the gross investment share of the economy has also increased over the same period, to a record high of 43 percent of GDP, from about 35 percent at the beginning of the decade.

This is arguably the first time in 50 years that economists have seen anything like it. Normally, a sharply rising investment ratio drives the current account into deficit: think, for example, of Southeast Asia in the run-up to the Asian financial crisis. Vice versa, Japan’s and Taiwan’s massive trade surpluses in the mid-1980s were due mostly to falling investment shares at home. This regularity has played itself out again and again in emerging markets across the globe, except in China, where a rising investment rate and a rocketing current account surplus have gone hand in hand.

What is going on? By definition, if both ratios are increasing, then it must be that the domestic saving rate is rising even faster, which in turn implies that the domestic consumption share of GDP must be falling—and falling precipitously at that. Sure enough, the official data show that overall Chinese consumption spending has fallen from more than 60 percent of GDP at the beginning of the decade to about 50 percent today, with household consumption at a record low of 37 percent of GDP. This is the smallest ratio in all of Asia, and perhaps in emerging market countries as well.

Clearly, something is more than a little bit “out of whack” in the vibrant, rapidly growing mainland economy, and the obvious conclusion from the above scenario is that weak consumption is the culprit. By implication, the solution to China’s domestic and external imbalances is urgent action to boost consumer spending, the only driver that can restore balanced growth.

That, in a nutshell, is the consensus version of events. However, as it turns out, there are also very good reasons to question that consensus, and a closer look at the macroeconomic data does in fact suggest that the real story lies elsewhere. I will argue in this article that household consumption is not the main problem; instead, the bulk of excess savings has come from Chinese firms as they “expropriate” market share and profits from the rest of the world. Moreover, this imbalance is a temporary rather than a structural phenomenon, and the economy is already in the process of self-adjusting. Of course China still needs longer-term structural reforms in the areas of consumer finance and the social safety net—but these are not the solutions to the current cyclical disparity.

### Three additional puzzles

How do we get there? Start by considering the following three additional economic puzzles:

*First, if household spending is so weak, why doesn't it feel weak?* The official GDP figures show consumption lagging well behind overall growth in the economy, but these are virtually the only numbers that point to a weak consumption performance. Retail sales growth has been in the double-digit range, rural consumption spending has rocketed in line with rising food prices, and annual urban passenger car purchases have tripled since 2002. Nor do Chinese consumers appear “underleveraged”; the rise of mortgage and auto finance has increased overall household debt significantly since the beginning of the decade.

*Second, if China is overinvesting so much, why aren't profits falling?* The investment data give rise to a similar conundrum: a sharply rising investment ratio combined with declining consumption should lead to weak and falling corporate profits, but official industrial data for the past five years show strong profitability. Industrial margins have declined somewhat since 2004, particularly in excess capacity sectors, but they remain very high by Chinese historical standards.

*Third, if consumer savings are exploding, why can't we find them?* By far the most telling critique of the consensus view

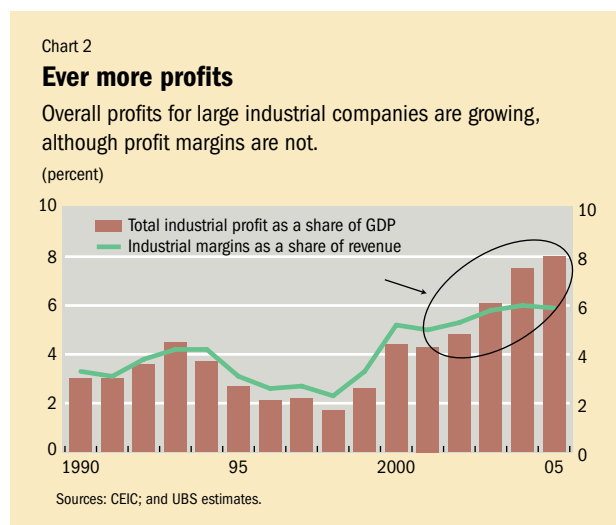
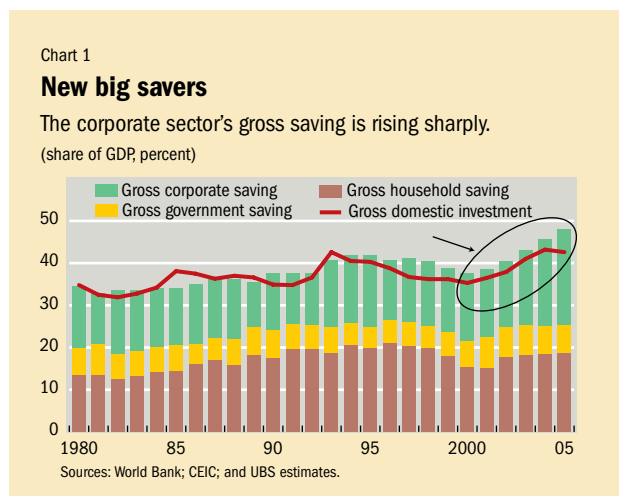
comes from the savings side of the equation. After all, actual consumption may be higher and investment lower than the official GDP numbers suggest—but the dramatic rise in the current account surplus over the past few years still implies a dramatic rise in savings, and any consistent exposition of Chinese imbalances must explain where those savings are coming from.

As best we can tell, they are not coming from households. Banking system data show that the household share in total deposits has fallen since the beginning of the decade, offset by a rise in the enterprise deposit share. This is confirmed by flow of funds estimates, which also indicate that while household and government saving rates are generally high, neither ratio has changed much over the past five years. Instead, the real driver of the recent Chinese “savings boom” is the corporate sector, in which the estimated gross saving rate has shot up by nearly 7 percentage points since the beginning of the decade (see Chart 1).

### Firms, not households

The implication is that the sudden appearance of China's imbalances over the past few years—the sharply rising trade surplus and the implied dramatic increase in domestic savings relative to the already very high mainland investment levels—was not caused by weak consumers. Instead, the bulk of the evidence points to Chinese companies and rising corporate savings as the source of the problem.

By definition, gross corporate savings are equal to total profits—that is, the amount of earnings available for investment or distribution to owners—and corporate profit margins have been strong but stable or even falling over the past five years. However, there is a big difference between profit margins and the volume of total profits in the economy, and the latter figures tell a different story. Since 2002, there has been a sharp divergence in the relative performance of margins and overall profits for large Chinese industrial companies as a share of GDP; and overall profits have skyrocketed as a share of the economy (see Chart 2). After accounting for



the profits of smaller manufacturing firms and the services sector, it is easy to see how the corporate sector has led the savings boom in China.

What accounts for the sudden divorce between margins and total profits over the past few years? The answer is that industrial sales volumes have risen enormously. For most of the past two decades, there was a stable relationship between industrial sales revenue and GDP, but, since 2002, the ratio suddenly jumped from 90 percent of GDP to an astounding 140 percent in 2005 (see Chart 3, top panel). What is more, this was not an across-the-board increase; instead, the jump has been concentrated solely in heavy industrial sectors.

And heavy industrial production rose much faster than domestic demand for industrial goods (see Chart 3, bottom panel). Of course, China has a rising surplus in light manufacturing and electronics industries, but the biggest single contributor to the trade surplus was the sudden turnaround in the trade position for heavy sectors such as steel, materials, machinery, and chemicals.

### The real story

As it turns out, the real story behind China's imbalances has little to do with consumption and everything to do with a large-scale net transfer of savings from abroad to the mainland corporate sector. Because of excess domestic capacity creation, heavy industrial companies have effectively expropriated savings from the rest of the world through abnormally high market share gains both at home and abroad. And rather than being a reflection of long-term structural imbalances, this is a profoundly cyclical shock that carries the seeds of its own reversal.

Here is how it works. From 2001 through 2005, the mainland economy saw an intense investment boom in construction and machinery-related sectors. The wrenching slowdown in domestic demand following macroeconomic tightening in 2004 would normally have cut production and wiped out profits in these sectors, but firms in key industries were able to "validate" capacity increases by taking local market share away from overseas suppliers, as well as boost their own export shipments. The result was a big fall in import growth and buoyant export momentum—that is, a rapid increase in the trade surplus. Profit margins did decline in overheated sectors, of course, but the market share gains allowed firms to record a big increase in volumes at home *and* better margins than they would otherwise have seen, which in turn helped push the massive increase in the level of corporate profits as a share of the economy. This explains the second big puzzle: why we have not seen more pressure on earnings and margins despite the record-high investment-to-GDP ratio.

The unusually high contribution of net exports to overall growth also raises the level of GDP relative to domestic demand and thus "artificially" pushes down the consumption share of the economy. And this helps explain the first puzzle: why the official household consumption ratio is falling despite buoyant consumption indicators on the ground.

### Popular recipes for rebalancing

So this, in short, is the working model here of Chinese macroeconomic imbalances: cyclical overinvestment in heavy industrial sectors, rising market share through trade adjustment, and higher domestic corporate savings as a result. Now, taking this model as a benchmark, here are the various prescriptions for rebalancing.

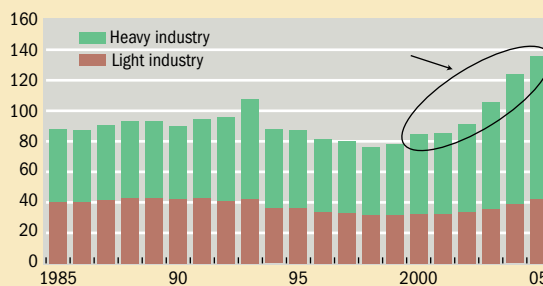
*Just get households to spend more.* Again, this view is probably the most common among China analysts and the financial press. However, it does not necessarily make a lot of sense. Chinese households do have a high average saving rate by international standards, but there is a big difference between high structural savings and cyclical excess savings. High structural savings, which are partly attributable to households, are the main driver of high structural investment and growth rates in the mainland economy. Lowering saving rates would lower average investment rates over the cycle and thus raise the structural return on capital, but it would also push down GDP and income growth. It is an open question whether this is an optimal outcome for China. Meanwhile, cyclical excess savings are a corporate issue rather than a consumer issue, and simply pushing higher consumption today to lower the trade surplus without addressing the factors underlying the

Chart 3

### Heavy lifting

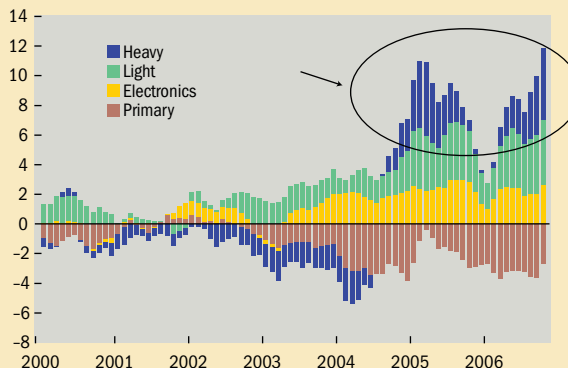
Heavy industry accounted for the sharp rise in sales volumes . . .

(industrial sales as a share of GDP, percent)



. . . which are driving the growing trade surplus.

(contribution to change in trade balance, billion dollars)



Sources: CEIC; and UBS estimates.

current imbalances could push already-overheated growth to absurd levels.

*Reduce corporate and government savings and redirect funds to households.* More seasoned economic specialists recognize these misconceptions and have focused instead on

**“A large revaluation may look good in theory, but it has so far proved virtually impossible to implement.”**

resolving the systemic factors behind Chinese imbalances: reducing China’s structural propensity for overinvestment by extracting dividend payments from mainland state-owned enterprises, introducing harder budget constraints through market reforms in the banking system, and redirecting financial surpluses from local government investment projects to social safety net protection for Chinese households (see “China’s Rebalancing Act,” page 27). This is true rebalancing, in the sense that it not only moves savings away from governments and firms toward households but also reduces systemic incentives for misbehavior. All of these prescriptions are now gradually making their way onto the official policy agenda. There is, however, one slight complication. These policies are uniformly long term in nature, aimed more at preventing the *next* bout of cyclical savings and investment imbalances than resolving *this* one.

*Consolidate heavy industry.* Should the government take immediate steps to reduce sectoral overcapacity by shutting down marginal firms and consolidating selected heavy industries? This would reduce both the level of corporate savings and the trade balance by reducing domestic supply relative to demand and boosting import growth. Although this is a great idea in theory, it has also proved to be a disaster in practice. The central government has been trying to restrict new investment and consolidate existing capacity in steel, aluminum, cement, autos, and so on, for the past three years with very few visible signs of success, and there is little to suggest that things will change radically going forward.

*Let the renminbi go.* The role of the exchange rate in Chinese imbalances is perhaps one of the most hotly debated topics on the academic policy scene today. The most common view on mainland external surpluses implicitly leaves little role for exchange rate adjustment as a means of rebalancing the economy. If the high trade balance reflects structurally weak consumption and excessive household savings, then it is not obvious how appreciating the renminbi would contribute to resolving the problem. By the same token, the main alternative explanation that trade surpluses were brought on by a significantly undervalued currency is generally silent on exactly how structural undervaluation resulted in such a sudden and dramatic rise in gross domestic savings.

In contrast to these two views, focusing on the role of cyclical excess capacity explains both the speed and the size of China’s trade adjustment and the sharp increase in gross savings, and also clarifies the role of the exchange rate. An undervalued currency has little to do with excessive investment and capacity creation—but renminbi strengthening can nonetheless play a key role in promoting ex post adjustment in the face of the resulting trade surplus, by switching expenditure back to overseas heavy industrial suppliers, speeding the exit of marginal import-competing producers, and reducing domestic corporate savings in the process.

A large revaluation may look good in theory, but it has so far proved virtually impossible to implement. The gradual pace of nominal strengthening to date has not had any visible impact on the trade balance or corporate profits, and political constraints act as a considerable barrier to a more sizable move in the renminbi exchange rate.

### **A natural rebalancing**

In the absence of a more rapid exchange rate adjustment, this leaves a “real” near-term rebalancing. The trends most likely to drive corporate earnings and the trade surplus back to more sustainable levels over the next few years are the gradual end of excess capacity growth, the subsequent return of net import demand, and lower overall GDP growth. These will achieve real near-term rebalancing.

To begin with, excess capacity expansion is nearing the end. This is not because of government policy, but rather because of normal market forces—profit margins have been propped up by unusually strong market share gains, but margins have nonetheless fallen in key overcapacity sectors such as autos, steel, and industrial materials. As a result, investment spending in these sectors is slowing, and this should help stem the enormous industrial production buildup of the past five years.

As this happens, the trade surplus should peak and eventually decline as China returns to a net import position in some of the industries listed above. There are limits to the ability of Chinese firms to exploit overseas markets or replace imported market share at home; the most successful sectors here have been homogeneous, commoditized materials such as steel, cement, and aluminum, whereas investment and margins in other areas, such as machinery, have been relatively more responsive to domestic conditions.

The final implication is lower GDP growth. The consensus view would actually argue for faster domestic spending growth as consumption accelerates, but the truth is that there is no sustainable way to rebalance the Chinese economy at GDP growth rates of 10.5 percent or 11 percent. China’s structurally sustainable real growth rate is about 9 percent, and it is to this level that the economy must return. Real rebalancing involves a slowdown in investment and a drop in net exports rather than a further pickup in urban consumption, and this is by far the most likely scenario through the end of the current decade. ■

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