China: Rebalancing... Under the Radar Progress

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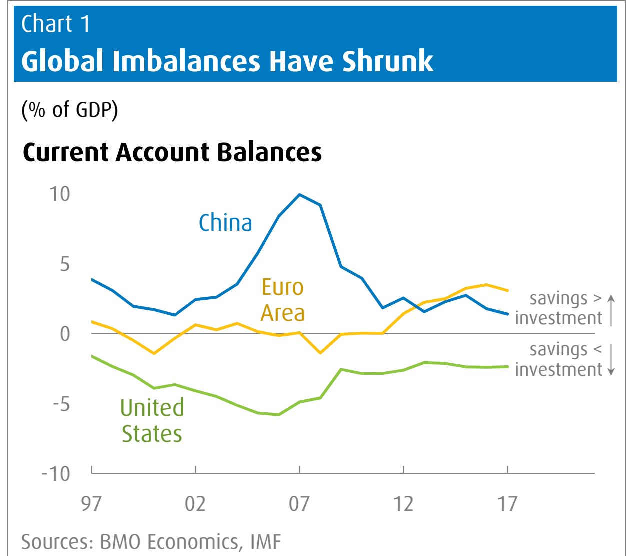
"Beijing—Inside a bubble economy, people begin to think that good times will last forever. That was true in Japan in the 1980s and in America in the late '90s. And it's true now in China—the 'miracle economy,' where the sun has been shining so brightly that many people don't see the clouds that are beginning to drift in."

—Washington Post, April 20, 2004

This quote remains just as relevant today as it was nearly a decade and a half ago. Predictions of 'imminent doom and gloom' are likely to remain a mainstay of newspaper headlines as long as China's economy continues to defy gravity or conventional, market-driven economic theory. Rather than focus on guesstimating the timing of a tail-risk probability of an economic crisis occurring (e.g., hard landing or banking crisis), we thought it would be helpful to **take a step back and assess how China's broader rebalancing process**—such as shifting the main drivers of growth away from investment/exports toward consumption—**has evolved**. Success on this front should help reduce the risk of an economic crisis (by lowering the reliance on debt-related investment), address global concerns of China's large merchandise trade surpluses, and also improve the prospects of maintaining long-term sustainable growth. The latter has historically proven more difficult to achieve for emerging markets that have reached the middle-income stage of economic development.

After all, rebalancing remains at the forefront of Chinese and global policy debates. Following its entry into the World Trade Organization in 2001, China's investment/export-led growth model was not only considered to be the key contributor to its own domestic imbalances (i.e., high investment and low consumption) but also to global imbalances, namely America's large current account deficit (*Chart 1*). Notwithstanding the rise in global trade protectionism, the somewhat forgotten news these days is that there has been a large correction in China's current account surplus, which has averaged a rather modest 1.9% of GDP over the past five years, compared to a peak of 10% in 2007. However, this could largely be attributed to a downturn in global demand in the wake of the Great Recession rather than to a sharp, fundamental shift in domestic consumption or investment trends[1].

Chart 1
Global Imbalances Have Shrunk



Rebalancing Domestic Demand is a Complicated Task

Progress in terms of either lifting the domestic consumption/GDP ratio (53.6% in 2016) or lowering the domestic investment/GDP ratio (44.2%) has been slower than the current account adjustment but this should not be considered surprising (*Table 1*). In our view, **rapidly shifting the trajectory of either consumption or investment** (to developed-market levels) **is unrealistic** as the factors underlying these trends are deep-rooted and ultimately require an extended period of adjustment. It could also be risky since the sudden prospect of a smaller pool of domestic savings

[1] Fundamental national income accounting identities ensure that the current account is equal not only to the difference between exports and imports, broadly defined, but also to the difference between savings and investment. Therefore, changes in savings or investment should lead to higher or lower current account balances.

Table 1
Projected Growth Pattern Assuming Steady Reforms and No Major Shocks

		2001-10	2011-15	2016-17	Projections 2016-20	2021-25	2026-30
Real GDP Growth	(% : avg. for period)	10.6	7.9	6.8	7.0	5.9	5.0
Structure of Economy	(% : end of period)						
Investment/GDP Ratio		47.9	44.7	44.2[a]	38.0	36.0	34.0
Consumption/GDP Ratio		48.5	51.8	53.6[a]	60.0	63.0	66.0
Industry/GDP Ratio		46.4	40.9	40.5	41.0	38.0	34.6
Services/GDP Ratio		44.1	50.2	51.6	51.6	56.1	61.1
Share of Employment in Agriculture		36.7	28.3	27.7[a]	23.7	18.2	12.5
Share of Employment in Services		34.6	42.4	43.5[a]	47.6	52.9	59.0

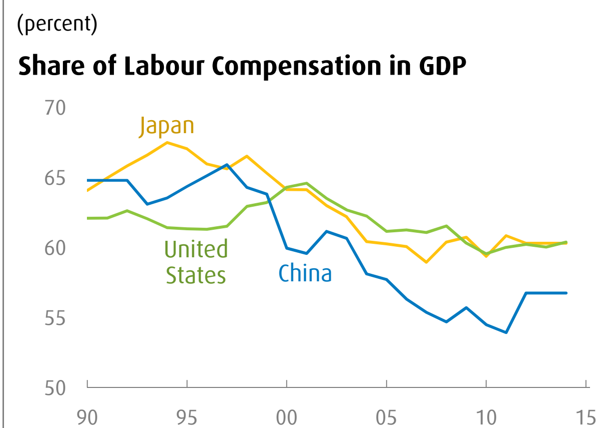
Sources: BMO Economics, Haver Analytics, National Bureau of Statistics of China, Development Research Center of the State Council, World Bank
[a] data is for 2016

would make it more difficult/expensive to finance investment.

Increasing the consumption ratio (or specifically lowering the household savings rate[2]) in China **is especially challenging** as it is linked to a myriad of complex, structural factors[3]—labour's share of national income, demographics, the healthcare system and job security[4]. Although most estimates show that the wage share of GDP (a fundamental driver of disposable income and, in turn, private consumption) has edged up of late, it is well below developed-market standards (*Chart 2*). While it seems reasonable to assume that wages will continue to take up a larger share of national income as demand for skilled labour intensifies, this process is likely to be gradual.

Meanwhile, structural reforms implemented in prior decades are likely to continue to suppress consumption. The one-child policy introduced in 1979 is often cited as a key driver behind the desire of households to save more (i.e., fewer children to provide old-age support). This policy ended in 2016 but it won't move the needle for years. Similarly, healthcare reforms in the early 1990s (which forced households to bear a larger share of healthcare spending) and state-owned enterprise reforms in the late 1990s (which ended the system of guaranteed life employment) are two key factors that have led to a sharp rise in precautionary savings[5].

Chart 2
Labour Income Lagging



Sources: BMO Economics, Federal Reserve Bank of St. Louis

Curbing Investment Has Its Limits

Lowering the investment ratio should be easier, at least on paper, as Beijing has vast powers at its disposal as the country remains largely a centrally planned economy. However, China has become increasingly market/privately driven and decentralized to the local/sub-national level[6], which has partially blunted Beijing's ability to curb investment.

[2] China's high savings rate largely emanates from the household sector as opposed to the corporate sector, which was the primary contributor in the 2000s.

[3] Zhang, Longmei. "IMF Working Paper: Rebalancing in China–Progress and Prospects." IMF, www.imf.org, September 2016.

[4] The use of financial repression—the authorities' ability to keep real returns on savings deposits low/negative—is also considered to be a key factor behind high household savings rates as both banks' deposit and lending rates were controlled until quite recently. Meanwhile, low lending rates are considered to be a key factor that has contributed to China's high investment rates.

[5] China has a complex pension system that is still in a state of transition. While pension coverage has expanded significantly since the early 2000s, concerns remain that the level of benefits are insufficient to meet retirement needs.

[6] Tax administration reforms in 1994 led to both functional and fiscal decentralization, which incentivized sub-national governments to pursue off-budget solutions (i.e., Local Government Financing Vehicles) to fund public infrastructure development.

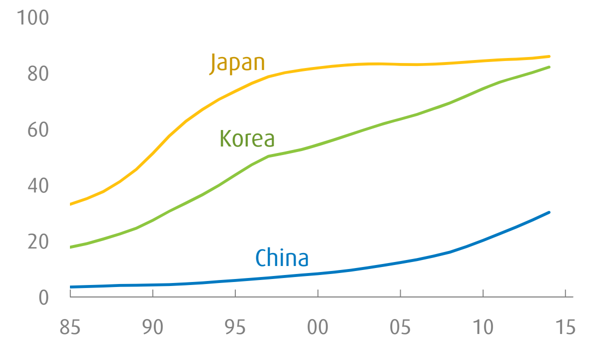
Soft budget constraints on state-owned enterprises (SOEs) have led to manufacturing overcapacity and inefficient investments[7].

More importantly, **Beijing's long-term objective to modernize and become a high-income economy** by 2030 means that clamping down too heavily on investment and, in turn, growth, could hinder these goals. Indeed, the two key pillars of China's modernization drive will continue to revolve around urbanization and industrialization. Although the urbanization process is quite advanced (59% in 2017 compared to 38% in 2001), it still has some ways to go to meet the government's target of 70% by 2030.

Chart 3
Capital Intensification Still Required

(% of U.S.)

Capital Stock per Capita



Sources: BMO Economics, Federal Reserve Bank of St. Louis

The continued focus on industrialization may seem somewhat puzzling as China is suffering from excess capacity and has already become a global manufacturing powerhouse. However, Beijing recognizes that the economy needs to become more productive to offset the negative effects of its rapidly aging population (i.e., rising old-age dependency ratio) and, in turn, prevent both deindustrialization and long-term growth prospects from falling too quickly. Industrial policy is now heavily geared toward **moving manufacturing up the value-added chain** by aiming to increase both the capital-to-labour ratio (we estimate that China's capital stock per worker stood at 30% of the U.S. level in 2014—*Chart 3*) and the pace of innovation.

Increasing innovation will not be easy as China will need to close the gap between its capabilities and that of the global technology frontier. To support this endeavour, in 2015, China introduced a **comprehensive long-term plan**—Made in China 2025 (MIC2025)—focused on developing new technologies in 10 strategic sectors[8]. A key objective of MIC2025 is to **increase the domestic content of core components and materials** produced to 40% by 2020 and 70% by 2025 in target sectors. Indeed, the domestication process may already be well on its way, which explains why merchandise imports excluding crude oil, measured as a share of GDP, have shrunk quite sharply in recent years (12.1% in 2017 versus 20% in 2007).

Key Takeaways

There is no guarantee that rebalancing will ultimately succeed, but recent developments have been encouraging. Yes, the process is likely to remain slow and uneven but this is in line with Beijing's long-term expectations. Nevertheless, rebalancing should yield important implications for investors concerning opportunities (e.g., a growing domestic services sector and a thriving IT industry) and challenges (e.g., shifting demand for global goods, particularly natural resources, and increasing overseas competition from Chinese companies such as those being promoted under the One Belt One Road Initiative[9]).

[7] Regional competition among provinces is strong, which has contributed to overcapacity in a number of sectors (e.g., coal, steel, cement, aluminum, ship building, solar energy, etc.) as central and local government objectives are not always aligned.

[8] The key sectors targeted in MIC2025 are (1) advanced IT, (2) aerospace and aeronautics, (3) agricultural equipment, (4) automated machines and robotics, (5) biopharma and medical products, (6) maritime equipment and shipping, (7) new-energy vehicles and equipment, (8) new materials, (9) power equipment, and (10) rail transport equipment.

[9] The Belt and Road strategy is designed to promote connectivity between Asia, Europe and Africa by developing high-speed railways, highways, seaports, industrial parks and energy infrastructure such as oil & gas pipelines and power grids.

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