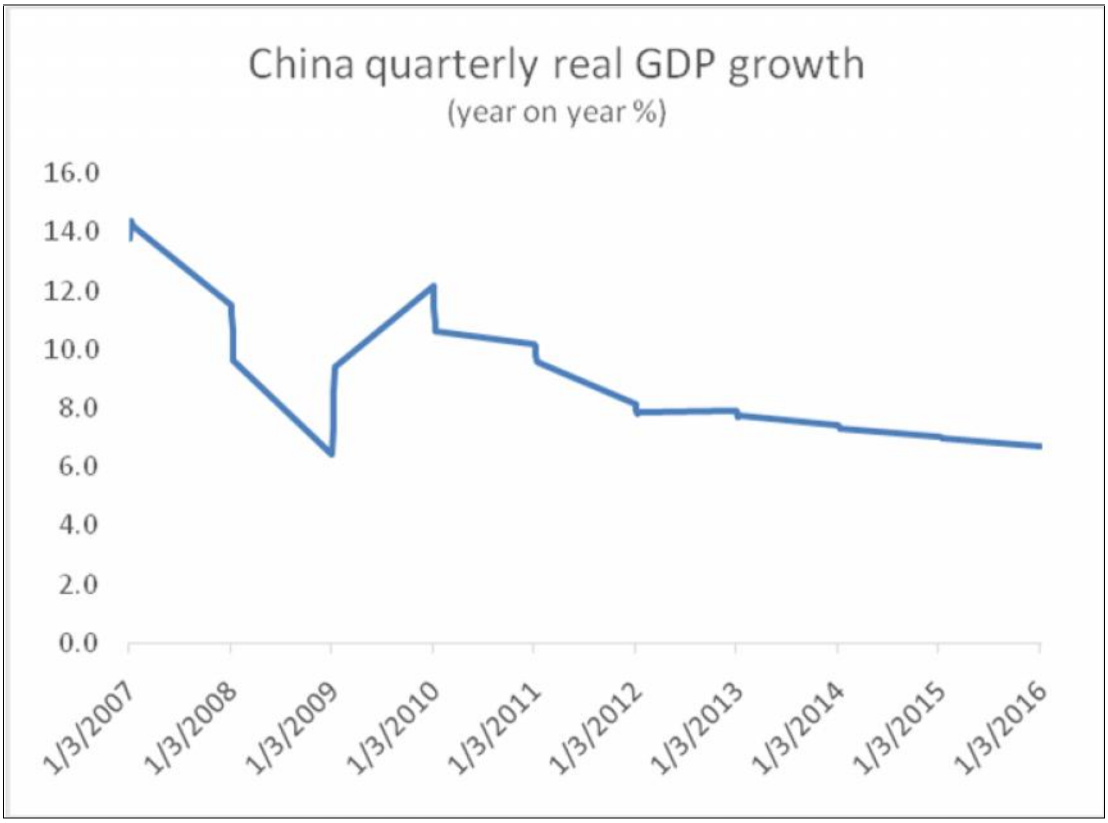
How Successful is China's Economic Rebalancing?*

C.P. Chandrasekhar and Jayati Ghosh

Over the past decade, there has been much talk of global imbalances, and of the need to correct them in an orderly way. But perhaps these imbalances are already moving towards some correction. The biggest sources of the imbalances were the large external deficits of the United States economy, which have been reducing for several years now. But one counterpart of that deficit was large external surpluses in China, which were also associated with extremely rapid GDP growth.

China's blistering pace of economic growth over the past three decades has certainly transformed both China and the global economy, but there are now clear signs that the pace is slowing. Chart 1 shows that quarterly rates of GDP growth (relative to the same period the previous year) have reduced to around 7 per cent or even slightly less in the past year, compared to rates higher than 10 per cent in several quarters in the period after the Global Financial Crisis. Despite the reduction, these are still high rates of growth.

Chart 1: Economic growth is decelerating but still quite rapid



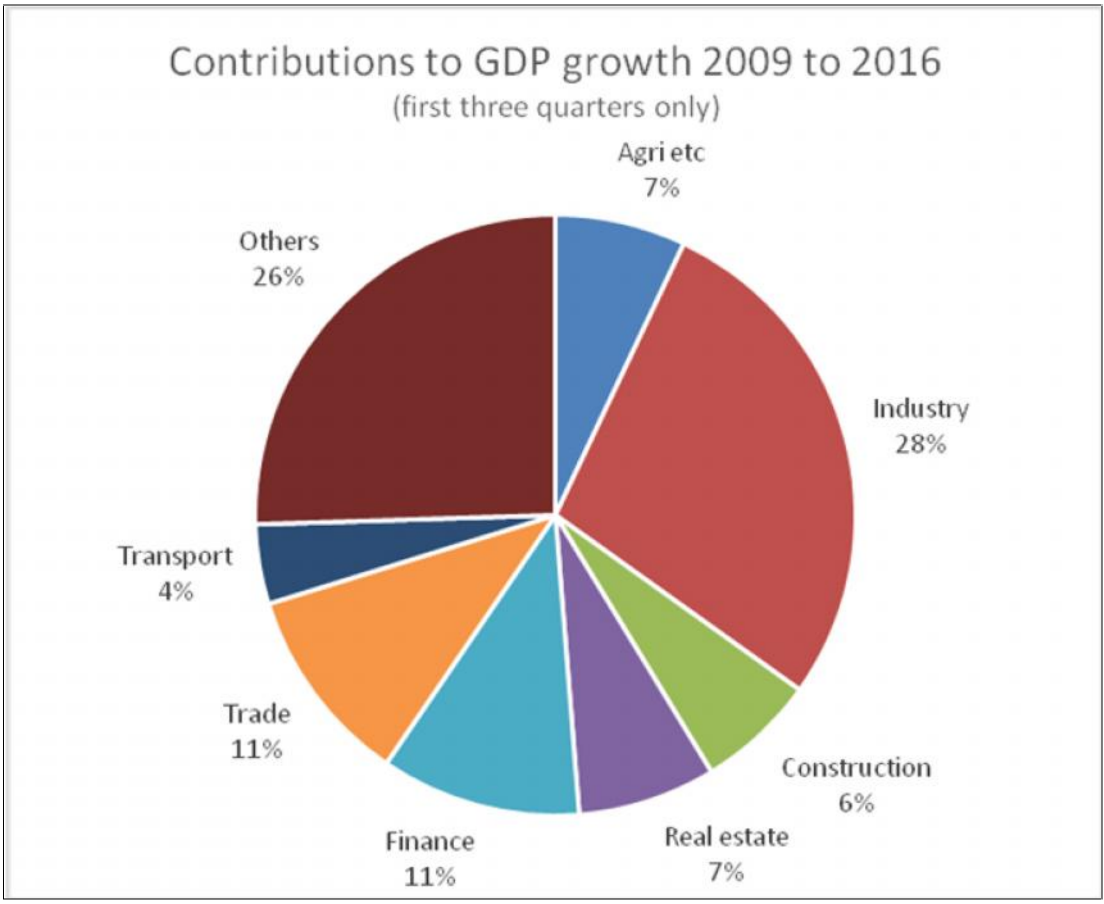
Source: Data for all charts calculated from China National Bureau of Statistics, data.stats.gov.cn

It is certainly the case that the kind of accelerated expansion of economic activity that China showed especially from the turn of this century would be hard if not impossible for any economy to sustain. In China's case, this growth was driven by extraordinarily high rates of investment, in the range of 45 per cent of GDP (and sometimes even more), which have also been historically unprecedented. Since savings rates were (amazingly) even higher, the associated current account surpluses allowed for the accumulation of huge foreign exchange reserves, at one point crossing $4 trillion in value.

China responded to the Great Recession from 2008 onwards with a stimulus package that put even more emphasis on investment, and relied on ever-rising levels of debt in all major sections of the economy. Previous editions of MacroScan have highlighted this issue, and the concern that even more debt is now required to generate smaller increases in income. There have also been concerns about whether this current focus on investment – especially in housing and other construction – would be successful in moving the economy towards a more consumption-led (and more sustainable) economic trajectory in future.

This is obviously an ongoing process, but an examination of the composition of the growth in economic activity since 2009 suggest that in fact it has been quite diversified. As Chart 2 suggests, industry (including manufacturing as well as infrastructure and utilities) has accounted for a healthy 28 per cent of the growth. And FIRE (finance, insurance and real estate) has accounted for only 18 per cent of the expansion.

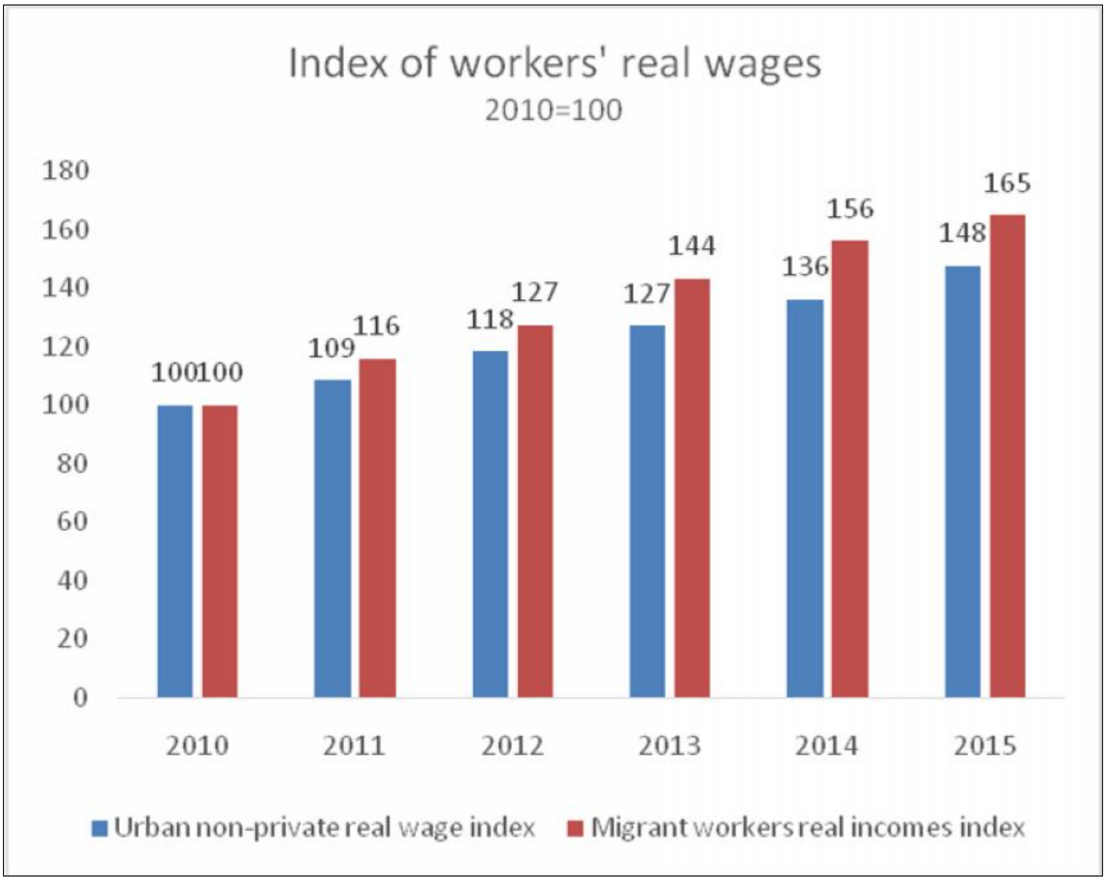
Chart 2: GDP growth has been quite diversified



What is more, this period has been marked by continuous increases in wages. Chart 3 indicates that workers' real wages have risen quite sharply, reinforcing the argument that many have made about China reaching the Lewisian turning point after which the presence of large amounts of surplus labour no longer prevents real wages from rising with aggregate economic expansion. Of course, wage increases also reflect political economy considerations and the relative power of workers vis-à-vis employers, which is also critically affected by government policies. (The Chinese experience is very different from the Indian case; in India, real wages have actually fallen recently even as GDP growth is estimated to be well over 7 per cent.)

Chart 3 admittedly shows the real wage index only for urban employees with the state or state-owned or collective enterprises and other non-private employment, so it may not reflect the conditions of the labour market for other workers in private units or those who are self-employed. But the index of real earnings of migrant workers (currently estimated to number around 176 million, largely from rural to urban areas) also shows very buoyant growth over this period.

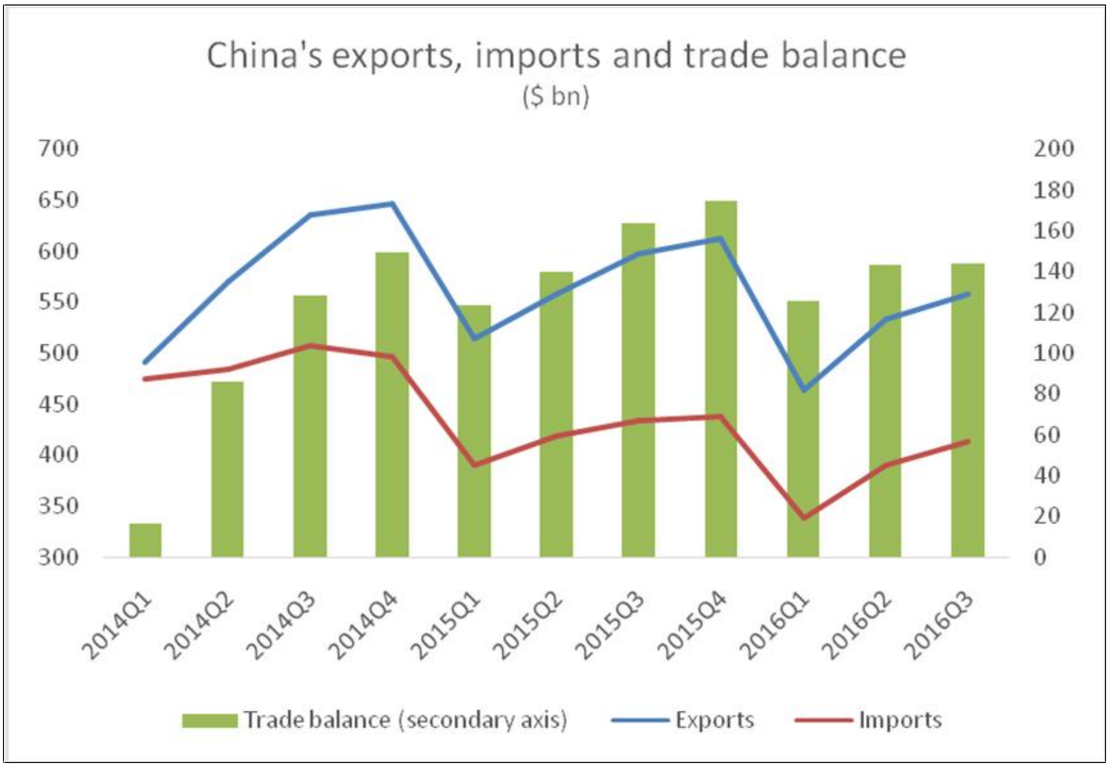
Chart 3: Workers' incomes show healthy increases



From this perspective, it appears that the deceleration of growth may be part of the desirable rebalancing of the economy towards one based on employment and wage growth, thereby generating consumption-led rather than investment-led growth over time, and reducing the extremely heavy dependence on the external economy that had marked the previous expansion. But some caveats are necessary. First, much of the recent expansion has been driven by rapid accumulation of debts that may well become unsustainable and certainly will require careful management in the immediate future. Second, since many of these debts were taken on for the purchase of housing and real estate, what happens in these markets is going to be very significant. Third, while the importance of exports is diminishing, they still remain significant, and the continuing slowdown in the global economy and in world trade will definitely have adverse effects on export-oriented enterprises and the large number of workers they employ. Fourth, all this ignores another serious threat to the Chinese growth process: the rowing environmental pressures, particularly resulting from pollution and degradation of natural resources, that are now affecting both production and the quality of life.

There is a further issue that is of great relevance for the rest of the world. While some significant changes are certainly under way in China, thus far they do not point to a rebalancing, at least in terms of the external account. Indeed, the trade surpluses generated by China show no signs of diminution, and have even increased in the recent past. Chart 4 shows quarterly trade indictors from the first quarter of 2014, and it is evident that while exports over all have not grown and have declined over the past year, imports have declined even faster. For the period from January to September this year, exports fell by 7.5 per cent but imports fell even more by 8.2 per cent. Over a two year period, the picture is even worse. Since their peaks in the last quarter of 2014, exports have fallen by 15.8 per cent in the most recent quarter, but imports have declined by as much as 22.6 per cent. So, far from reducing, the trade surpluses have been rising again – but this time because of import compression rather than export expansion.

Chart 4: But China's positive impulse for rest of world economy is fading



This is obviously very bad news for China's trading partners, and particularly for those in developing Asia for whom China had emerged as the dominant source of imports and well as the main destination for exports. China is no longer a source of positive stimulus either for the global economy or for the Asian region, at least in trade terms. And that is going to have severe consequences that are still not factored in by most analysts.

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