from the countryside into higher paying urban employment. Slower GDP growth, however, is not likely to threaten this justification for their rule if growth continues at a respectable rate of say 5 per cent a year for another two decades. The surplus of labour in the countryside has fallen and there are now labour shortages that are leading to accelerated wages and hence incomes and that will continue even at a slower GDP growth rate. There is a clear need to provide housing and other services for the migrants that until now have been largely neglected and that will justify continued large government investments in housing, healthcare, and education, although not as much housing investment as in the recent past. A major problem roughly two decades from now will be that the one child family policies that contributed to the large demographic dividend of the past two decades will give way to a major problem of a large ageing population and a shrinking labour force to support those elderly. Even with continued fairly rapid growth, meeting the future needs of both the working and elderly households will become a major challenge. If growth were to slow markedly below 5 per cent or 6 per cent a year, however, the working population in less than two decades would be pitted against the ageing population in a struggle for a share of a pie that was no longer growing and a challenge would become a crisis.

9 Rebalancing China's growth

Ligang Song

The call to rebalance economic growth in China is primarily motivated by the structural problems within China as well as in its economic relations with the rest of the world. China's international payments surpluses during the first decade of the twenty-first century have corresponded with deepening domestic structural risks to China's economic growth and development. These structural challenges include the composition of growth resulting from China's dynamic internal transformation, China's trade orientation, the trajectory and intensity of resource use and CO₂ emissions, welfare problems of distribution, and international market constraints. It is thought to be necessary for China to confront these challenges now in order to put the growth path on a more sustainable trajectory for the future. However, China faces huge challenges in addressing its economic imbalances and sustaining growth against a backdrop of heightened domestic and international uncertainty (Deer and Song, 2012).

The role of policy should be to design and implement a framework that reduces distortions, encourages and rewards innovation, equalizes access to education, employment, a social safety net, and capital for investment, while minimizing rent seeking opportunities. The desire to achieve such an environment will create a demand for institutional reforms that can facilitate these processes of structural change in the least disruptive fashion (McKay and Song, 2012).

Unbalanced domestic expenditure refers to China's high, and growing, share of investment relative to consumption in the expenditure measure of GDP. The external payment imbalance refers to China's current account, trade account, and private financial account surpluses. While the list of Chinese economic characteristics that deserve the label 'unbalanced' are legion—including the level of the exchange rate, the urban–rural income divide, the coast–hinterland divide, and asymmetries in the degree of access to credit, education, social security and housing—at some level they all relate to and inform the basic macro-economic structure and the external payments position.

Catch-up growth driven by rapid capital accumulation can be sustained for decades in capital-poor transitional economies with an abundant supply of labour. China's still relatively low level of income per capita and capital stock per worker, in addition to its

relatively low (policy suppressed) urbanization rate and the relative backwardness of its central and interior provinces, argue that concentrated growth on the Chinese mainland could potentially continue for longer than it did for its neighbours, including Chinese Taiwan and South Korea.

China's investment-led growth model is coming under increasing scrutiny due to the increasingly unhelpful international environment in which it finds itself now, in addition to the sheer heft that China exercises as the world's largest manufacturing exporter, pollution emitter, and commodity consumer. Furthermore, the costs of resource intensive growth—via high pollution and energy intensity—are becoming increasingly apparent. The low share of household consumption in total expenditure is a result of both a high marginal propensity to save and the low wage share of income at the national level, and until recently declining real rural incomes.

China's total manufacturing trade balance was in net surplus from as early as 1994, but this was concentrated in lower value added manufactures and was initially offset by a net deficit in heavier machinery and transport sectors. However, the machinery and transport equipment balance turned to surplus and rose sharply from 2004 to 2008. This turnaround in the machinery and transport equipment balance was the result of rising investment in heavy industry in the early 2000s (Anderson, 2008), which led to a sharp rise in heavy manufactured goods output and an expanding market share abroad and import substitution at home when capacity came on stream from 2004. Yet this sharp rise in output was not matched by an equivalent rise in domestic or foreign demand and, thus, the rise in market share led to falling prices, a lower rate of profit, and continual deterioration of China's terms of trade (McKay and Song, 2010).

The legacy of China's pre-reform heavy industrial structure and its institutional and policy architecture have led to a pattern of growth marked by widening imbalances that are more pronounced than those seen in other industrialization drives, and which were not present in the initial stages of China's reform. China's domestic expenditure and external imbalances widened in the 2000s as a result of China's stalled institutional reforms in the 1990s, and this has reinforced an investment-led industrial structure, especially in heavy industrial production and real estate development. The current growth pattern highlights the opportunity costs of stalled structural reform areas, such as the migration and labour market systems, vertical fiscal relations, state-enterprises, and the financial system.

Three sets of market-enhancing institutional reforms are therefore necessary: reform of the labour system, reform of the financial system, and reform of the government system, particularly in regards to the local government and state enterprise sectors. The interdependence of the Chinese economy with the world economy also suggests the significance of these channels for international rebalancing (Deer and Song, 2012).

The key is shifting the economic environment and incentive structure within which China's economic entities operate. The rebalancing policy objectives are to raise the domestic absorptive capacity of China's economy, through raising the relative share of

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The key is shifting the economic environment and incentive structure within which China's economic entities operate. The rebalancing policy objectives are to raise the domestic absorptive capacity of China's economy, through raising the relative share of

consumption in final expenditure, rather than by seeking to reduce the net role of exports; and to direct resources further away from the relatively inefficient into the more productive sectors of the economy through an improved market mechanism.

The effective (as opposed to spatial) urbanization of China's migrant workers is the most effective and realistic mid-term policy strategy for rebalancing China's macro-economy. Institutional reform can accelerate the long-run processes of migration and urbanization in China, which would raise domestic demand and, thus, reduce both the internal and the external imbalances in China's macro-economy and shift the current unbalanced industrial structure. A policy of urbanizing rural migrant workers by removing threshold barriers to urban residency and ensuring equal access to social housing, education, healthcare, and social protection are likely to raise consumption by migrant workers (Song et al., 2010).

The process of urbanization requires investment in urban infrastructure (such as mass transit and utility provision) and in service industries. The effect, combined with higher domestic consumption by migrant workers, would be to raise growth and enhance structural change. Urbanizing China's rural migrant workers would also help to integrate China's still segmented labour markets and provide a basis for long-term real wages to rise. Real wage gains can accelerate structural change by raising household consumption in domestic demand and by providing a basis for real currency appreciation. That can help shift China's industrial structure towards the tertiary sectors, which would benefit from the broader and deeper consumption basket of the better remunerated household sector.

Capital market reforms are necessary for China to rebalance in three related areas: the allocation of capital, the cost of capital, and the link between domestic financial reform and exchange arrangements. Although China's bank-dominated financial system deepened its asset base considerably over the reform period, China's system of formal credit allocation has remained narrow, and is mainly directed to the state-sector as state owned banks (SOBs) continue to dominate the sector. China's state-owned commercial banking sector allocates capital at rates which are low relative to those prevailing in private markets or a broad indicator such as the growth rate of nominal GDP, which reinforces the wider structure of investment and expenditure imbalances.

It will be difficult to develop domestic financial markets without further liberalization of the foreign exchange system or of financial (capital) account controls. The two spheres are mutually reinforcing, even circular. The exchange rate remains the anchor for China's monetary policy and any move towards a flexible currency needs to be accompanied by a shift to a different anchor. Current efforts to build up the interbank lending market and thereby establish a benchmark short-term interest rate to serve as this anchor shows some promise. A feasible reform would be to seek to incorporate China's large informal financial sector into the official financial system, in tandem with a removal of administrative ceilings on bank deposit rates and floor lending rates. The objective would be to create a legal sector of smaller non-bank financial lending and deposit institutions. These

firms would compete with the banking system to provide market-based contract terms for households and small and medium-sized enterprises (SMEs).

Following fiscal reforms in 1994, the majority of government revenues have been collected by the central government, while local governments have remained responsible for the majority of public and social expenditure, especially on healthcare and education. As a consequence of this fiscal and governmental system, not only do local governments have a powerful incentive to maximize growth, but they have an overriding fiscal incentive to do so through driving new investments, such as in real estate, in which they have direct or indirect claims to income, rather than through raising consumption.

The current pattern of local government investment—and outlays, more broadly—could be better directed to meeting the needs of China's current urban and migrant populations by directing more expenditure to social housing, and educational and social services (such as healthcare, retirement income, transportation, unemployment insurance, public space, and environmental amenity). There is much more to be done to reform the fiscal system at central and local government levels, including shifting the current land-transaction tax system to a property valuation and rates system.

SOEs have accounted for much of the sharp rise in heavy industrial profits and enterprise savings in the period since 2000. The monopoly position of China's SOEs also poses a longer-term challenge to the reform of China's industrial structure towards a more balanced trajectory. However, they also suggest an inefficient allocation of capital across sectors, which also reflect the still large distortions in China's factor markets, which cumulatively benefit the SOE sector disproportionately (Huang and Wang, 2010).

The pressures that are currently building will ultimately convince China to accelerate the pace of structural adjustment including the pace of liberalizing its capital account with the full convertibility and 'internationalization' of the RMB. China's eventual success in achieving the objective of rebalancing will also depend on how China's major trading partners seek to overcome their own structural problems. The global economy will be challenged to maintain the rate of expansion required to return balance sheets to health while demand centres and relative prices continue to shift.

Tackling China's economic imbalances necessitates economic policy reform to facilitate a more sustainable pattern of growth that will fundamentally alter China's industrial structure and its trade orientation. Rebalancing will direct a new pattern of growth, which requires a major alteration of the current industrial structure and the institutional arrangements associated with it, thereby leading to slower but higher quality growth consistent with the ultimate objective of China's economic transformation: to achieve an improved standard of living for the Chinese people in the most efficient and equitable way.

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