# The Chinese economy is rebalancing, at last

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April 3, 2018

Opinion Chinese economy
We are seeing a necessary change towards more reliance on consumer demand

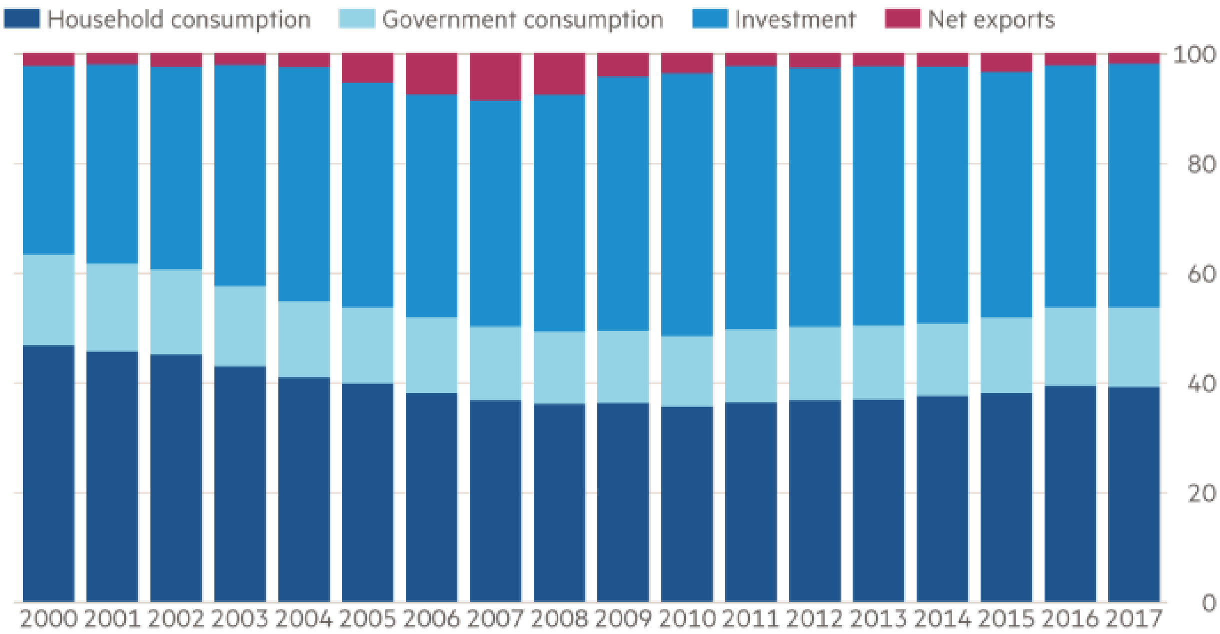
Martin Wolf

Consumption is at last becoming the most important driver of demand in the Chinese economy. This is a long-awaited and desirable adjustment. It promises to shift China away from its excessive reliance on inefficient, debt-fuelled investment. But it still has a long way to go. As the shift is being completed, the country will need to manage an overhang of bad debt. But the adjustment has begun.

In 2007, premier Wen Jiabao argued rightly that “the biggest problem with China’s economy is that the growth is unstable, unbalanced, uncoordinated and unsustainable”. In that year, gross national savings were 50 per cent of gross domestic product, up from 37 per cent in 2000. These huge savings financed domestic investment of 41 per cent of GDP and a current account surplus of 9 per cent.

## Rebalancing to consumption begins ...

The composition of China's demand (% of nominal GDP)




Source: Haver Analytics

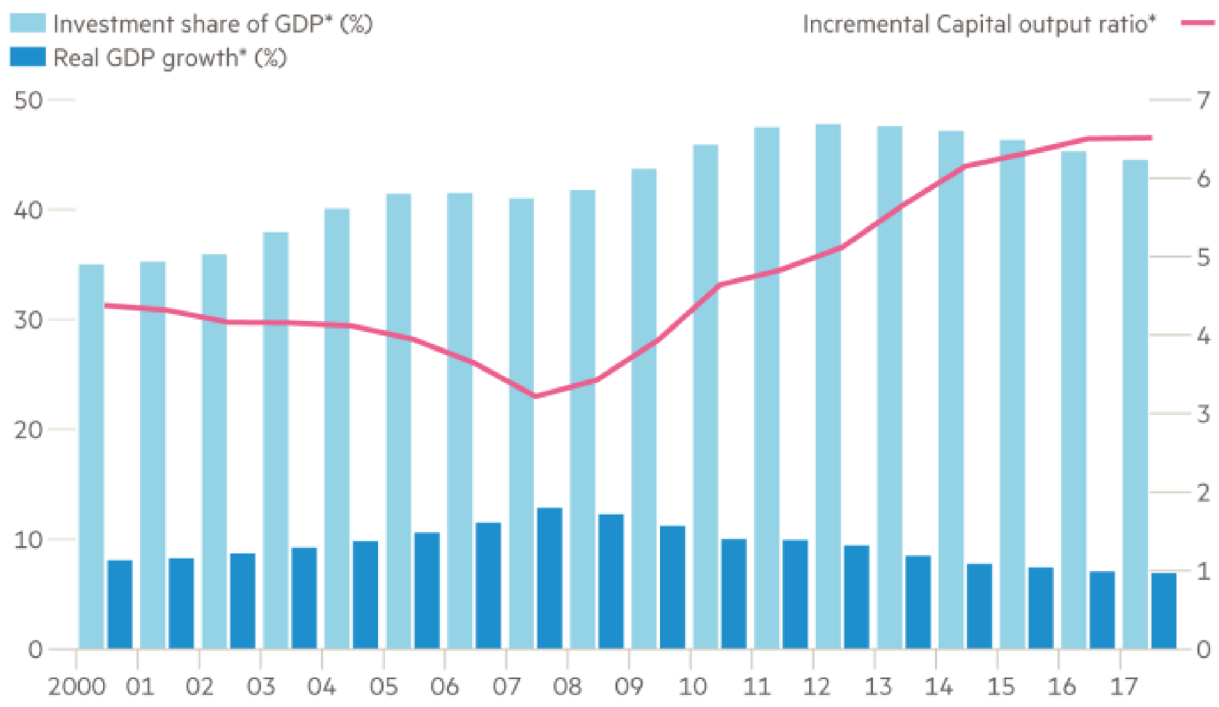


Then came the global financial crisis. The Chinese authorities promptly realised that the current account surplus had become unsustainable. In the short run, the only way to avoid a slump was to expand investment further. In 2011, gross investment reached 48 per cent of GDP and the current account surplus fell to 2 per cent. But national savings remained at 50 per cent of GDP. (See charts.)

This solution brought new problems. The first was a declining return on investment. The simplest way of showing this is via the incremental capital-output ratio (ICOR), which measures the amount of investment needed to generate a given increase in output. This has roughly doubled since 2007. That is not surprising: the investment rate has jumped, while growth has nearly halved. Moreover, the rise in the ICOR may well understate the true decline in returns: as Michael Pettis of Peking University's Guanghua School of Management argues, useless investment does not contribute to GDP.

The second problem is that the increased investment was driven by a huge rise in debt. According to the Institute of International Finance, gross debt rose from 171 to 295 per cent of GDP between the fourth quarter of 2008 and the third quarter of 2017. This is very high for an emerging country. Moreover, half of the increased debt went to non-financial corporate entities, which did much of the increased investment. A substantial portion of this increased debt may prove to be bad. Starting from the dramatic rise in the credit-dependence of growth, London-based Enodo Economics argues that the needed debt write-offs might ultimately amount to 20 per cent of GDP. This might seem big. But it would be manageable for a creditor country with a largely closed financial system.

## ... and return on investment falls




Source: Haver Analytics; FT research * average over previous 3 years
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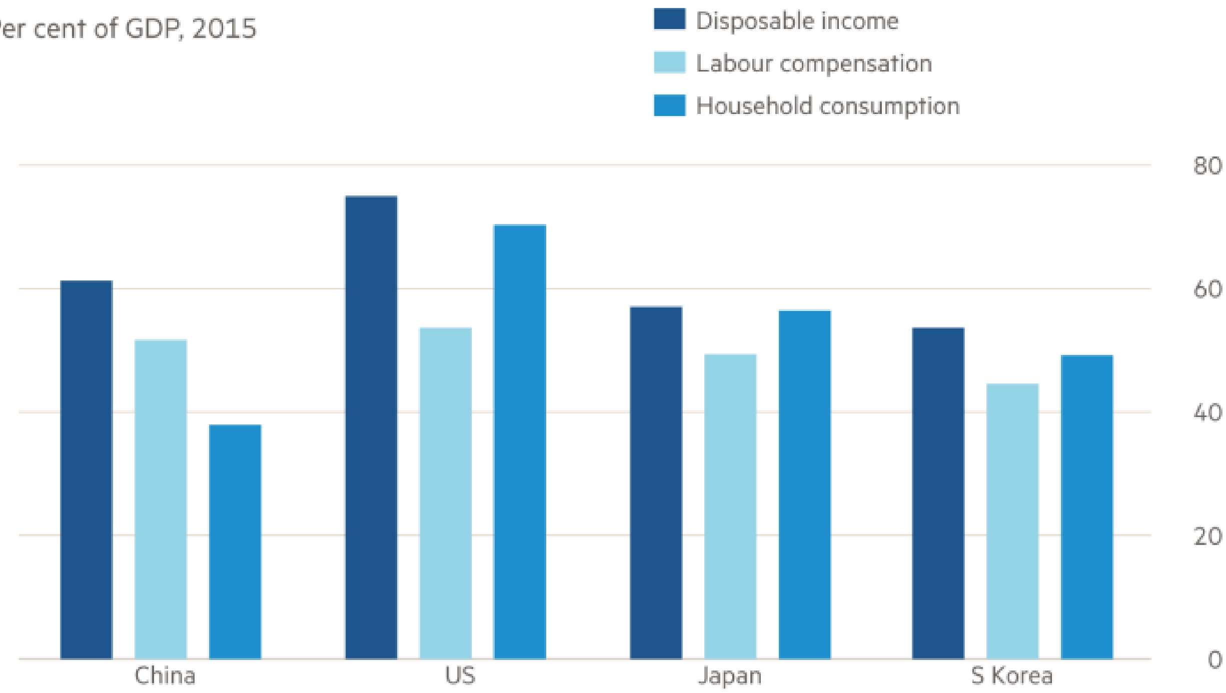
Up to 2014, then, nothing had happened to make the Chinese economy seem any less unstable, unbalanced, uncoordinated and unsustainable. On the contrary, China had merely replaced an excessive current account surplus, with still more excessive investment, soaring debt and property bubbles.

The past three years have witnessed change at last: investment has fallen by 3 per cent of GDP, while public and private consumption have risen by much the same proportion. As a result, consumption has become a more important source of additional demand than investment. Thus, in 2017, notes a background paper to this year's China Development Forum, final consumption contributed 59 per cent of GDP growth. As investment growth has declined at long last, the rise in indebtedness has also (apparently) stopped.

## ... as wages rise ...

Per cent of GDP, 2015



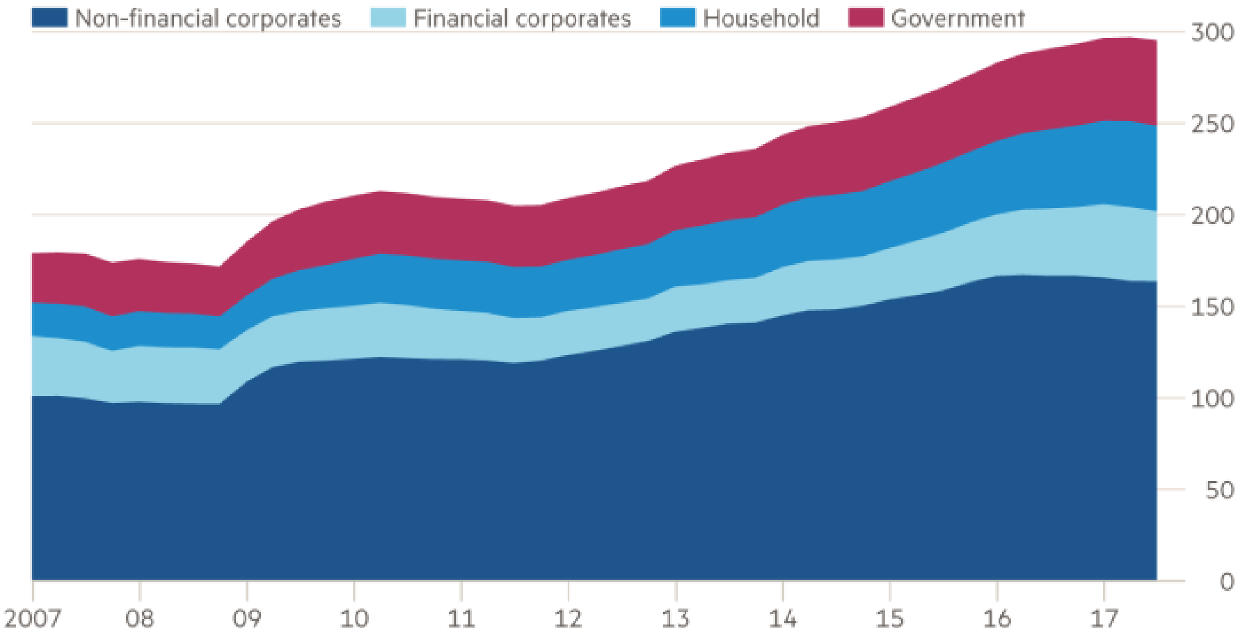

Sources: Enodo Economics; CEIC


Behind this has been a willingness to substitute quality for quantity of growth. Explanations for this willingness include the shrinkage of the labour force and a slowing of the rate of rural-urban migration. The increasingly service-driven economy of today is also more employment-intensive than the heavy-industry driven economy of the past. With the labour force now shrinking and growth more employment intensive, real wages have soared, raising the share of labour in national income. Enodo Economics argues that in 2015 the share of household disposable income and labour compensation were already higher than in Japan and South Korea.

It is only because the household savings rate is still very high in China that private consumption is so low a share of GDP. As ageing takes hold, that is likely to change, possibly quite quickly. If the government were to provide an adequate safety net and better health and education services, as well, the household savings rate might fall sharply. If so, the investment rate could also shrink to a more appropriate level. After all, it is still substantially higher than it was in 2007, let alone 2000.

### ... debt growth slows ...

Chinese debt, by sector, as a % of GDP




Source: Institute of International Finance


In brief, while the shifts are slow and the full adjustment to more reasonable levels could take until the middle of the next decade, we are seeing early signs of the necessary change in the structure of the Chinese economy towards one that is less unbalanced and, above all, one that is more reliant on the consumer demand of China's vast population. That would, in turn, be good for China and for the rest of the world.

Good policy could also accelerate the shift, by increasing the transfer of profits to the people, via ownership, taxation or, better still, a bit of both. It is more or less inevitable that a clean up of excessive debt will also be needed, together with substantial reform of the financial sector. But that would also become far easier if the huge imbalances — above all, the excessive reliance on investment — were at an end.

The chances of achieving desperately needed rebalancing and even of managing that transformation fairly smoothly are rising. The story told by former premier Wen is far from over. But we can now at least envisage a happy ending.

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