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China – Rebalance to Avoid the Middle Income Trap

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China's new leadership must rebalance the country's economy if it is to avoid falling into the middle income trap. Yet slowing growth rates make drastic reforms politically sensitive at a time when the new leadership needs to maintain stability in order to consolidate their power. This policy brief explores some of the options.

In November, the Communist Party of China held its 18th National Congress, in which the once a decade leadership change took place. President Hu Jintao and Premier Wen Jiabao will be succeeded by Xi Jinping and Li Keqiang respectively. During the reign of the previous leadership, China has maintained high and sustained growth rates and become a middle income economy.[1] But economic growth was also unequally distributed and unbalanced towards investment and exports. As the new leadership takes over, China faces the threat of falling into the middle income trap.

A country risks falling into the middle income trap when it can no longer compete with low wages, while being unable to achieve the productivity of more advanced high income economies. The link between economic imbalances in China and the middle income trap was the focus of the World Bank's "China 2030" report and the Asia Development Bank's "Asia 2050" report.

Structural imbalance has grown rapidly, with capital formation increasing from 36 percent to 48 percent of GDP from 1999 to 2009, while household consumption fell from 46 percent to 35 percent during the same period.[2] In response to the global financial crisis China launched a 4 trillion Yuan stimulus package, which led to a boom in fixed investment and further imbalances. If China is to become a upper middle income and eventually a high income country, these imbalances need to be corrected. However, slowing growth rates make drastic reforms politically sensitive at a time when the new leadership needs to maintain stability in order to consolidate their power.

Options for Rebalancing

In the aftermath of the stimulus package a growing consensus emerged that China should rebalance towards increased domestic consumption, a commitment that was explicitly stated in the 12th Five Year Plan.[3] Rebalancing towards domestic consumption would present several benefits for the country, including increased economic scope for the service sector and decreasing reliance on investments and exports. Growth would arguably become more stable and sustainable, albeit likely at a slower rate. China has come under pressure from dwindling global demand, however voices have been raised to once again encourage fixed investment.[4] This becomes especially tempting in order to maintain social stability vis-a-vis the change in leadership. Such efforts will put rebalancing on hold and may exacerbate the current imbalances even further.

Several reforms have been suggested to realign China's economic structure. The most prominent proposals are for monetary reform, the privatization of State Owned Enterprises (SOEs), increased wages and social spending.[5]

Investment in China is supported by low interest rates, which transfers wealth from household savings to lending investors. Liberalized interest rates and increased competition among banks would lead to increased interest rates reversing the flow of wealth in favor of households[6], stimulating consumption and moderating the risk of overinvestment. Another debated monetary reform is appreciation of the Yuan, a source of friction between China and the US. Appreciation of the Yuan would decrease the competitiveness of Chinese exports, but increase the purchasing power of the Chinese consumers.

China's SOEs face soft budget constraints in comparison to private firms because of their easy access to credit, favorable policies and dominant market position within their sectors. Soft budget constraints increase the risk of poor investment decisions and reduce the incentives to maximize profit.[7] Privatization and competitive access to credit would promote productivity because of the increased incentives for profit maximization. A leveled playing field which grants private small and medium enterprises better access to credit will also stimulate the growth of the private sector.

In the past low wages have served China's export oriented growth model well. Today, however, China faces an upward pressure on wages. In order for the economy to rebalance towards consumption, this trend must be allowed to continue. This issue is reflected in the 12th Five-Year Plan[8], where the aim is to increase the minimum wage by 40 percent by 2015.

Finally, another way to help rebalance the Chinese economy is by increasing the level of social spending, including pension fund coverage. Although coverage of health insurance has expanded over the last decade, to 95 percent, it is uneven and covers only 41 percent of rural patient costs.[9] Spending on health care and social security would decrease the incentives for Chinese depositors to maintain high saving rates and stimulate consumption.

Obstacles to Rebalancing

The suggested reforms mentioned above aim to rebalance the Chinese economy. In doing so, they challenge many historically entrenched interests in China, both within the business community and the Communist Party of China.

Higher interest rates would create higher returns for depositors, but also put pressure on the export sector and increase credit costs for the overall economy. Of course, there is no guarantee that Chinese depositors, who often save for health care, old age and housing, will increase spending solely because of higher deposit rates. Similarly, while a stronger Yuan would benefit the Chinese consumer, it will hurt the ability of China's manufacturing sector to compete, not just internationally but also domestically. The risks entailed in a rapid reform will likely slow the pace of financial and monetary reforms, allowing the manufacturing sector to adjust to this new environment.

There are signs that China is encouraging private investment in sectors previously monopolized by SOEs.[10] Privatization challenges the entrenched interests of SOE management, employees and political elite. Furthermore, privatization could increase short-term unemployment and thereby social insecurity within the urban sector, all risks that will discourage rapid reform in the midst of leadership change.

China should continue to push for higher wages, especially minimum wages, in order to encourage consumption and reduce socioeconomic inequality. If higher wages are not coupled with increased productivity, the country's international competitiveness will suffer. It is neither possible nor desirable to reverse this trend. Higher wages coupled with rebalancing towards domestic consumption are central to avoid the middle income trap and should not be discouraged. China needs to promote productivity to allow for the necessary wage increases.

Expanding the social safety net is necessary for China in the long-term, even though full coverage may prove difficult to achieve due to the rapidly aging population. Increased public spending has several advantages over other reform suggestions. It is easier for the government to achieve than private consumption and it does not challenge entrenched interests to the same extent as other proposals, as long as it is properly financed. China's Central government is in a good position to continue its expansion of fiscal spending.[11] However, any investment in China's social safety net will be expensive and care must be taken not to overburden the already heavily indebted local governments.

Rebalancing the economy is a vital part of creating more equal and sustainable growth in the future. The new leadership must show courage to challenge powerful entrenched interests against any reforms, both within the business community and the party itself. If they are not able to address these challenges, China risks getting stuck in the middle income trap.

Endnotes

1 China Daily, accessed 2012-06-11, http://www.chinadaily.com.cn/bizchina/2009-09/08/content_8667416.htm
2 China Statistical Yearbook 2010, 2-17, 2-18
3 APCO Worldwide, China's 12th Five-Year Plan, 10 December 2010
4 China Daily, accessed 2012-09-26, http://www.chinadaily.com.cn/china/2012-09/26/content_15782884.htm
5 The Word Bank, China 2030
6 China Financial Markets, accessed 2012-05-07 http://www.mpettis.com/
7 Barry Naughton (2006), 308-310
8 APCO Worldwide (2010)
9 The Economist, May 26th 2012, "Dipping into the kitty", 15-17
10 Xinhua, accessed 2012-06-07, http://news.xinhuanet.com/english/china/2012-05/28/c_131614946_2.htm
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