CHAPTER FOUR

The Case of Unbalanced Growth in China

China in recent years has generated what is probably the largest trade surplus as a share of global GDP in history. Although many analysts describe this as evidence of a very successful growth model in which the trade surplus derives from good planning and fundamental strengths within the Chinese economy, it turns out that the Chinese trade surplus is actually a symptom of very distorted and unsustainable domestic policies, the reversal of which will be fraught with difficulty. It is a mistake to characterize China as an export-driven economy. China is an investment-driven economy. The trade surplus is a residual result of investment-related policies that force up the savings rate to levels above the investment rate.

So far we have been discussing the factors that affect trade balances in fairly abstract terms, so it might be useful to look at a specific case of a country with a number of policies in place that force up the national savings rate and, with it, a trade surplus. China, as is well known, has in the past decade experienced the largest trade surplus in the world, and as a share of global GDP its trade surplus may be the highest—or certainly among the highest—ever generated in history.

But China also has an extraordinarily high investment rate, the highest in the world, and this is something that is in principle unlikely to be accompanied by a high trade surplus. After all the current account surplus is exactly equal to the excess of savings over investment, and any country with an extraordinarily high investment rate should naturally run a current
account deficit, as domestic savings are insufficient to exceed domestic investment. But China runs a huge current account surplus. This implies that China must also have an exceptionally high savings rate—one high enough fully to satisfy domestic needs and yet with enough excess to generate a very large surplus.

In fact China does have an extraordinarily high savings rate, and in this chapter we consider the reasons for such high savings. Before going further it is important to note that an excessively high savings rate can be just as debilitating for an economy, perhaps even more so, as an excessively low savings rate.

Many analysts find this hard to believe. There is a tendency for analysts to be overly U.S.-centric when considering economic conditions in China and many other countries—and this is a problem not just among American and other non-Chinese analysts, but even among Chinese analysts. The United States clearly suffers from a low savings rate, and the consequences of a low savings rate are widely understood, so analysts tend to assume that only low savings can be a problem, whereas on the other hand high savings must be a good thing and extraordinarily high savings must be an extraordinarily good thing.

But this is not the case. In fact as we saw in chapter 1, excessively high global savings were central to the speculative capital flows and trade imbalances that led to the global crisis, and countries like China were at the heart of the savings excess. China’s very unbalanced economy—unbalanced in the opposite way of that of the United States and in an even more extreme form—has generated its own internal problems—very different from the problems in the United States—and this is an important part of the story of trade imbalances. Unfortunately the analysis in the previous two chapters suggests that it might be even more difficult for a country like China to adjust to a rebalanced world economy than it will be for the United States.

It is worth stepping back briefly to understand the domestic problems created by these imbalances and to note for how long these problems have been apparent. On the morning of March 16, 2007, in Beijing’s Great Hall of the People, Wen Jiabao, China’s premier at the time, held a press conference just before the end of the Fifth Session of the Tenth National People’s Con-
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gress. After questions from reporters from several different media organizations, including the Wall Street Journal, the People’s Daily, China’s CCTV, Le Monde, and the Financial Times, a reporter from China News Service asked the premier the kind of question that should have been a layup:

China’s growth rate has exceeded 10% while the inflation rate has been kept below 3% for four years running. This is rare both in China and the world. Some scholars believe that China’s economy will reach a turning point in 2007. What’s your view? What do you think are the major problems in China’s economy? Will China be able to maintain such a momentum of high growth and low inflation?

Premier Wen’s response was surprisingly frank, and his characterization of the economy caused a sensation:

China’s economy has maintained fast yet steady growth in recent years. However, this gives no cause for complacency, neither in the past, nor now, or in the future. My mind is focused on the pressing challenges. “A country that appears peaceful and stable may encounter unexpected crises.” There are structural problems in China’s economy which cause unsteady, unbalanced, uncoordinated and unsustainable development.

Within minutes of his ending the press conference headlines flashed around the world proclaiming that Premier Wen had called China’s development “unsteady, unbalanced, uncoordinated and unsustainable.” This was the strongest possible confirmation of what skeptics had long been arguing—China’s growth model was seriously lopsided and for all its seeming success could be storing important adjustment problems for the future.

Premier Wen went on to elaborate what he meant by those words:

Unsteady development means overheated investment as well as excessive credit supply and liquidity and surplus in foreign trade and international payments. Unbalanced development means uneven development
between urban and rural areas, between different regions and between economic and social development. Uncoordinated development means that there is lack of proper balance between the primary, secondary and tertiary sectors and between investment and consumption. Economic growth is mainly driven by investment and export. Unsustainable development means that we have not done well in saving energy and resources and protecting the environment. All these are pressing problems facing us, which require long-term efforts to resolve.

I have said that China’s economy has enjoyed fast yet steady growth for years. Can we sustain this momentum? First, the conditions are there. The most important condition is that we have a fairly long peaceful international environment that enables us to focus on economic development. Second, we have a domestic market with huge potential. However, the key to sustaining the momentum of China’s economic growth lies in our ability to pursue the right policies.

We will continue to expand domestic demand, especially consumption. We will press ahead with reform and opening up to remove institutional and structural obstacles and enhance knowledge and technology based innovation. All this will lay down a solid foundation for ensuring economic growth. We will further promote energy and resources saving and reduction of pollutant discharge to make economic growth sustainable. The task is a difficult one, but we are confident that we can accomplish it.

For the next several days and weeks commentators applauded the premier’s forthrightness and discussed the meaning of the phrase “unsteady, unbalanced, uncoordinated and unsustainable.” This, however, was not the last time Premier Wen was to worry publicly. Two and a half years later when it seemed to many, even though the imbalances signaled by Wen had all gotten worse, that China had managed altogether to sidestep the global crisis, on September 10, 2009, in a speech at the World Economic Forum in Dalian, a city in northeastern China, Premier Wen made a very similar claim. “China's
economic rebound,” he told the attendees, “is unstable, unbalanced and not yet solid.”

And within the most senior policymaking circles it was not just Wen Jiabao who worried. In June 2010, writing in the government-owned Qiu Shi magazine, Vice Premier Li Keqiang—who was anointed the next premier after the change in leadership in late 2012—said that China’s past development has created an “irrational economic structure” and “uncoordinated and unsustainable development is increasingly apparent.”

He added that China’s long-term dependence on investment and exports for growth “will grow the instability of the economy.” During 2010 and 2011 rumors swept the community of China-watching economists that Li was pressing for interest rate increases and other steps necessary to force a more rapid adjustment, but given the lack of consensus and the risks associated with the leadership change, he had not been able to get his way.

For the rest of 2011 and 2012, even with the great reluctance among policymakers to take strong and possibly controversial stands during a once-in-a-decade leadership transition period, the debate about rebalancing became louder. In September 2011 at the World Economic Forum in Dalian, professor Zhang Weiying, former dean of the very prestigious Guanghua School of Peking University, China’s most reputable university, lambasted the inability of the leadership to manage the pace of reform. He described the very powerful National Development and Reform Commission, the bureaucrats who produce and manage the country’s economic blueprints, as “a bunch of smart people doing something really stupid.”

It has become a contentious debate. Proponents of one form of rebalancing, which involved significant political and economic liberalization, fought for what was often referred to in the press as the “Guangdong model,” versus the more statist “Chongqing model,” which would, perhaps a little mysteriously, also deliver rebalancing of the economy but under stricter state control and preferably through the leadership of the “revolutionary” families. In early 2012 an astonishing series of events resulted in the deposition of Bo Xilai as mayor of Chongqing and the presumed leader of “Chongqing model” faction that opposed significant reforms.
For many commentators Bo Xilai's downfall, he was subsequently suspended from the twenty-five-person Politburo in April, had to do mainly with his unseemly populist behavior in attempting to force himself into the nine-man Standing Committee, the most senior policymaking body in China. But a more plausible explanation was that his downfall was simply part of the contentious debate—although an especially colorful part—between reformers and antireformers, and it should not have been unexpected.

Most political commentators believe the debate will continue after the leadership change as the reformers try to build a consensus for what is sure to be a difficult transition period. The difficulty is that any rebalancing will require, by definition, an inversion of the relative growth rates of the state and household sectors. This will not be easy. For the past decade, as China grew by 10–12 percent annually, household income grew by 7–8 percent annually while the state sector grew by nearly 15 percent annually.

Rebalancing will require, as I demonstrate in the rest of this chapter, that household income grow faster than GDP, and so by definition the state sector must grow more slowly. Even if we accept what I believe are excessively optimistic average annual growth expectations of 7 percent for the next decade, for China to rebalance, the average growth rate of the state sector cannot exceed 5 percent annually (and I believe GDP growth rates will be much lower than 7 percent). The transition from a state in which the accumulation of state assets grows by roughly 15 percent or more annually to one in which it grows by less than 5 percent will be at the heart of the distributional struggles among Chinese factions and prominent Chinese families.

What Kind of Imbalance?

Is China's growth "unbalanced," and if so, in what sense is it unbalanced, and how does that affect the trade account? Most commentators pretty much agree that China's economy is indeed unbalanced, and they agree on the nature of the fundamental imbalances. Chinese growth is unbalanced because the very rapid GDP growth generated especially in the past decade has re-
lied too heavily on net exports and investment and too little on domestic household consumption. The most striking expression of this imbalance is the declining share of GDP represented by household consumption.

The story of Chinese consumption since the 1978 reforms is instructive. In the 1980s household consumption represented about 50 to 52 percent of GDP. This is not an unprecedented number, but it is very low. Consumption for most European countries lies in the 60 to 65 percent range. Consumption for other developing countries can easily fall in the 65 to 70 percent range—within which range much of Latin America lies. Consumption in the United States has been around 70 to 72 percent in recent years.

By Asian standards, however, Chinese consumption in the 1980s was not exceptionally low. South Korean and Malaysian consumption is around 50 to 55 percent of GDP (although during and after the Asian crisis Malaysian consumption did drop to around 45 percent of GDP, before recovering after a year). Other major Asian economies, like India, Japan, Taiwan, and Thailand, show consumption in the 55 to 60 percent of GDP range.

Nonetheless, even though it started the decade at the low end of the range even for low-consuming Asian countries, as the country grew during the 1990s Chinese consumption declined further as a share of GDP. By the end of the decade Chinese household consumption represented a meager 46 percent of GDP. This was not unprecedented—Malaysian consumption after all had dropped to 45 percent a year after the 1997 crisis—but the Chinese consumption level was more typical of a country in crisis than of a country in ruddy good health.

But the story doesn’t end there. By 2005 household consumption in China had declined to around 40 percent of GDP. With the exception of a few very special and unique cases, this level is unprecedented in modern economic history. Beijing’s response to this very low number, not surprisingly, was a worried one. Policymakers pledged during 2005 to take every step necessary to raise household consumption growth and to help rebalance the economy.

Why were they worried? Because, as we pointed out in chapter 1, in any economy there are three sources of demand—domestic consumption, domestic investment, and the trade surplus—which together compose total
demand, or GDP. If a country has a very low domestic consumption share, by definition it is overly reliant on domestic investment and the trade surplus to generate growth.

This meant that future Chinese growth was vulnerable. Policymakers, of course, cannot fully control the trade surplus because this depends on the ability and willingness of the rest of the world to continue absorbing China's deficient demand. With the largest trade surplus ever recorded as a share of global GDP—all the more astounding given that the two previous record holders, Japan in the late 1980s and the United States in the late 1920s, were countries whose share of global GDP was two to three times China's share—it wasn't at all obvious that China could expect its trade surplus to increase much more.

Furthermore there was also already a great deal of concern that China's high investment rate was proving unsustainable. Beijing had engineered for China extremely high and growing investment rates for the previous twenty-five years, and this made a great deal of economic sense at the beginning of the reform process, after 1978, when China was seriously and obviously underinvested for its level of social development. But after so many years of furious investment growth, there were increasing worries that China had become overinvested, perhaps even massively overinvested, by the early and middle part of the decade.

We will more fully discuss China's vulnerability to the trade surplus and investment later in this chapter, but with consumption so low, it would mean that China was overly reliant for growth on two sources of demand that were unsustainable and hard to control. Only by shifting to higher domestic consumption could the country reduce its vulnerability and ensure continued rapid growth. This is why in 2005, with household consumption at a shockingly low 40 percent of GDP, Beijing announced its resolve to rebalance the economy toward a greater consumption share.

Not surprisingly most observers, both foreign and Chinese, hailed Beijing's new resolve to raise the consumption share of GDP and excitedly reported that with these new initiatives the problem of a too-low household consumption share was about to be addressed and fixed. There was a wide-
spread perception that Beijing had always managed to achieve its economic targets in the past, and this new economic target would also be dispatched with efficiency.

A few economists, however, were very skeptical. They pointed out that previous policy successes had almost always involved targets that could be resolved mainly by increases in investment. The real lesson, they argued, was not that Beijing was able to manage the economy efficiently and intelligently; it was that Beijing was able to increase investment whenever it wanted. Given low transparency, limited political accountability, and near-total control over national savings and the banking system, perhaps this should not have been a surprise.

Rebalancing the economy toward consumption, however, could not be achieved by mandating higher investment. On the contrary, it would require lower investment. This, the skeptics argued, would make the target much harder to achieve because when it came to achieving economic targets that could not be met simply by increasing investment, it was not clear that Beijing had ever been very effective.

They further argued that a low and declining consumption share of GDP was not an accident; it was fundamental to the growth model. China did not grow quickly, in other words, in spite of lagging consumption growth—it grew quickly because of lagging consumption growth. In that case Beijing would not be able to raise the consumption share of GDP easily because doing so would require abandoning the investment-driven growth model altogether, and there was as of yet no political consensuses in favor of taking the necessary drastic steps. They warned that consumption would barely grow from the 40 percent level for many years and might even stagnate further.

It turned out that even the skeptics underestimated the difficulty of the adjustment China was facing. For the next five years GDP growth continued to surge ahead of household consumption growth until by 2010, the last year for which we have complete statistics as of this writing, household consumption declined to an astonishing 34 percent of GDP. This level is almost surreal. For all its determination, in other words, not only was Beijing wholly
incapable of reversing the downward trend in the household consumption share of GDP, it could not even prevent a near collapse.

The flip side of the decline in consumption of course has been the rise in savings, which is simply the obverse of consumption. Part of the rise in savings has been the rise in household savings. After bouncing around erratically between 10 percent and 20 percent of disposable income in the 1980s, by 1990 Chinese household savings equaled 12–15 percent of disposable income. Around 1992 household savings began rising steadily until 1998, and then stabilized at around 24–25 percent until very recently, when they rose slightly to about 26 percent of disposable income.

**Growth Miracles Are Not New**

But this is not the whole story—household savings are only part of total national savings. The real increase in national savings in recent years was caused by the sharp increase in corporate and government savings, although it is worth pointing out that corporate savings, and even government savings, are themselves caused by the transfer from household savings via low interest rates and other hidden transfers, as we will see later. Corporate and governments savings, in other words, were savings effectively imposed on the household sector.

During this three-decade period China ran small surpluses or deficits on the trade account from 1978 until 1996, when it booked its last trade deficit, beginning thereafter a steady upward march of its trade surplus until 2003, when the trade surplus was around 5 percent of China’s GDP. After 2003, China’s trade surplus surged, to reach over 10 percent of GDP in 2007–8, before coming down sharply in 2009 and 2010 as a result of the global crisis in demand.

Investment, too, rose steadily during this period as a share of GDP, as indeed it had to if the growth model was going to work. In 1990 it was around 23 percent of GDP. It rose sharply in 1992–94 to around 31 percent of GDP, stabilized at that level, and then began climbing inexorably around 1997–98 to reach 50 percent in 2011, and even more if we include, as we should,
imported commodities that are stockpiled (rising inventories are a form of investment).

Rising investment, rising savings, and rising trade surpluses are inextricably linked in China's case, and nothing suggests how impressive was the increase in China's national savings rate as the fact that China was able to combine a soaring investment rate with a soaring trade surplus. Because, as we showed in chapter 1, the trade surplus is a function of the excess of savings over investment, normally a high and soaring investment rate should be associated with a declining trade surplus, or even (and more normally) a large and rising trade deficit.

This is what happened, for example, in the United States during the nineteenth century, when very high domestic investment rates exceeded domestic savings, and the United States had to import foreign capital, mostly from Great Britain and the Netherlands, for most of the century. As the obverse, of course, the United States also ran trade deficits for most of the nineteenth century. Yet China, with an even higher investment rate, one of the highest in history, was able nonetheless to run an extraordinarily high trade surplus. The only way this could happen is if the savings rate was even more extraordinarily high.

And it was, but why? We have already discussed the many policies, ranging from undervalued currencies, to lagging wage growth, to financial repression, to environmental degradation and weakening social safety nets as policies or institutional structures that encouraged very rapid growth but at the expense of the household share of that growth. All of these occurred in China to an exaggerated extent, and it was for these reasons that Chinese savings soared.

These growth strategies engineered by Beijing forced households to subsidize investment and production, thus generating rapid economic and employment growth at the expense of household income growth. It is the lagging growth in household income, as we showed in the previous two chapters, that has primarily constrained household consumption growth.

This is borne out by the numbers. From 1990 to 2002, household income ranged from 64 percent of GDP to 72 percent of GDP. It peaked in 1992,
before a tremendous bout of inflation in 1993 and 1994 brought it down, and then began a slow, erratic descent to 66 percent in 2002, after which time it plunged to under 50 percent of GDP, if the numbers can be believed (most analysts assume that there is substantial hidden income in China, especially among the wealthy and very wealthy, that is not captured in the official surveys).³

If there were a way to measure changes in wealth—for example the value of the deteriorating social safety nets and the degrading environment, the present value of savings as interest rates are changed for policy reasons, etc.—and household income were adjusted by these changes, the decline in household wealth relative to GDP would have probably been even greater. Certainly that is what the savings numbers imply.

But with Chinese household consumption and household income growing so rapidly in the past decade, around 7–8 percent annually, why has it been so difficult to raise the consumption share of GDP and reduce China’s overwhelming dependence on a growing trade surplus and especially accelerating investment to generate growth? In order to understand the causes of China’s great imbalance it is necessary to consider the development model that generated its tremendous growth in the past two decades.

There is nothing especially Chinese about the Chinese development model. It is mostly a souped-up version of the Asian development model, probably first articulated by Japan in the 1960s, and shares fundamental features with a number of periods of rapid growth—for example Germany during the 1930s, Brazil during the “miracle” years of the 1960s and 1970, and the Soviet Union in the 1950s and 1960s, when most informed opinion (including, apparently, President Kennedy) expected the country to overtake the United States economically well before the end of the century. While these policies can generate tremendous growth early on, they also lead inexorably to deep imbalances.

At the heart of the various models are massive subsidies for manufacturing and investment aimed at generating rapid growth and the building up of infrastructure and manufacturing capacity. These subsidies make it very cheap to increase investment in manufacturing capacity, infrastructure, and
real estate development, generating enormous growth in employment, and they allow investors, whether private or, more typically, the state, to generate great profitability.

The Brazilian Miracle

But of course, as we showed in chapters 2 and 3, all subsidies must be paid for by someone, and in nearly every case they are paid for by the household sector. In some cases, as with the Brazilian investment-driven miracle in the 1960s and 1970s, the household costs are explicit. Brazil taxed household income heavily and invested the proceeds in manufacturing and infrastructure. In doing this it managed to achieve eye-popping growth rates. As MIT professor Yasheng Huang put it tantalizingly in a Wall Street Journal piece,

Guess which country boasted the following characteristics: GDP grew at 11% annually for almost 10 years. The authoritarian, one-party state promoted rapid industrialization by relocating workers to coastal urban areas. The government welcomed foreign-direct investment and courted companies through tax exemptions and other benefits. Seventy-five percent of the top 100 largest domestic firms’ assets belonged to the state sector. The government’s savings rate doubled in less than a decade, while the agricultural share of employment fell by more than one-third over the same period.4

Of course Huang was talking not about China but about Brazil from 1965 to 1974, during which time it may have been the first country to which the term “economic miracle” was applied to describe the astonishing growth surge. That miracle was achieved by using high levels of income tax to confiscate household wealth and use the proceeds not to improve social benefits but rather simply to subsidize the ferocious spurt of growth.

This is not necessarily a bad strategy. Brazil achieved extraordinary growth, and with it, income levels rose quickly. But as the history of every
investment-driven growth miracle, including that of Brazil, shows, high levels of state-directed subsidized investment run an increasing risk of being misallocated, and the longer this goes on the more wealth is likely to be destroyed even as the economy posts high GDP growth rates. The difference between posted GDP growth rates and real increases in wealth shows up as excess debt. Eventually the imbalances this misallocation creates have to be resolved, and the wealth destruction has to be recognized as debt levels are paid down.

With such heavy distortions imposed and maintained by the central government, there was no easy way for the economy to adjust on its own. Growth was not capable of being sustained except by rising debt, and by the mid-1970s Brazil reached its domestic debt capacity limit, as loans simply could not be repaid out of earnings. Fortunately for the administration of President Ernesto Geisel—but unfortunately for Brazil—the contraction of domestic debt capacity coincided with the petrodollar crisis, in which international banks had to recycle soaring dollar earnings from OPEC nations with few opportunities to deploy these earnings in Europe and the United States, which were then suffering from economic stagnation.

The petrodollars were recycled in massive amounts in developing countries, including miracle-growth Brazil, that were able to continue funding high levels of wasteful investment and maintain GDP growth, even with the oil price shocks of the 1970s, at nearly 6 percent. But of course excess debt continued to rise. Because the external funding too had its limits, by 1981-82 after the accompanying debt levels proved to be a limit to further expansion, Brazil spent much of the 1980s, its famous Lost Decade, reversing the growth that occurred during its miracle years. Debt, as we will learn over the next few years in China, has always been the Achilles' heel of the investment-driven growth model.

There are however some important differences among forms of the investment-driven growth model. The Asian or Japanese variety relies on less explicit taxation mechanisms to accomplish the same purpose of subsidizing investment. Rather than confiscating household wealth through high income taxes, as the Brazilian version of the model did, three much more indirect mechanisms are used for the same effect, as we discussed in chapter 3.
First, wage growth is constrained to well below the growth in worker productivity. In China, for example, worker productivity has grown much faster than wages, especially during the past decade, during which time workers’ wages have slightly more than doubled, while productivity has nearly tripled.

There are many reasons for the gap between the two. One reason, as we also discussed in chapter 3, may have to do with the huge pool of surplus labor in the countryside available to compete for jobs and so keep wages low. There are also other, policy-related reasons that limit wage growth. Workers are not able to organize except in government-sponsored unions that more often see things from the point of view of employers than from that of workers. Migrant workers are also unable to get residence permits, called hukou, and without hukou what limited protection workers may have is sharply reduced because living in an urban area without the proper hukou is tolerated but technically illegal.

The important thing to remember from the growth model perspective is that, whatever the reason, lagging wage growth in China represented a transfer of wealth from workers to employers. An increasing share of whatever workers produced, in other words, accrued to employers, and this effective subsidy allowed employers to generate transferred profit or to cover real losses. The fact that productivity grew much faster than wages acted like a growing tax on workers’ wages, the proceeds of which went to subsidize employers.

And remember the impact this hidden tax has on the relationship between GDP growth and household income growth, as we discussed in chapter 3. By effectively subsidizing employers at the expense of workers, it boosted the competitiveness of businesses, and increased overall production, while constraining household income, and with it, household consumption. This forced up China’s savings rate.

The second mechanism common among Asian development model countries for transferring income from households to manufacturers, as we also have already discussed, is an undervalued exchange rate, and most analysts acknowledged that after the massive devaluation of the renminbi in 1994, followed by soaring productivity (which increased the real undervaluation
of a currency), the renminbi was seriously undervalued for much of the past two decades.

It is not wholly meaningful to discuss by how much the renminbi was undervalued because any undervaluation of the currency must be considered in conjunction with the other transfers that had similar impacts on the trade balance. Most economists, however, have estimated the undervaluation to be anywhere from 15 percent to 30 percent, which given long-term changes in productivity and inflation is probably a reasonable if imprecise estimate.

Powering Growth

Clearly this represents a significant undervaluation. The undervaluation of the exchange rate, remember, is a kind of consumption tax imposed on all imported goods, and everyone in China who is a net importer, which includes all households except perhaps subsistence farmers, must pay this very large implicit tax.

On the other hand Chinese manufacturers in the tradable goods sector, heavily concentrated in Guangdong and the coastal provinces, receive the opposite “negative” tax, or subsidy, in the form of lower domestic costs relative to higher foreign prices for their goods. Again we must remember the impact this hidden consumption tax has on the relationship between GDP growth and household income growth. By raising the cost of foreign imports, it puts downward pressure on real household income in China.

But by subsidizing Chinese exporters, thus increasing their competitive strengths relative to foreign competitors, the undervaluation of the renminbi boosts domestic production. An undervalued exchange rate is simply another powerful mechanism for increasing the gap between what a country produces and what it consumes, and this forces up the savings rate, not only affecting the trade account, as we showed in chapter 2, but with high GDP growth being created through high investment growth, an undervalued currency also creates domestic imbalances in the way growth is generated.
The third mechanism for creating the domestic imbalances, and probably by far the most powerful, as we discussed in chapter 3, is financial repression. The Chinese financial system is, or has been until very recently, severely repressed. Almost all household savings in China are in the form of bank deposits, and the banks are controlled by the monetary authorities, who determine the direction of credit, socialize the risks, and set interest rates.

In China, the central bank, the People's Bank of China, following instructions of the State Council, sets both the maximum deposit rate, above which banks cannot pay, and the minimum lending rate, below which banks cannot lend. Because it sets both rates very low, it is effectively transferring a large share of resources from depositors to borrowers.

How large a share? In the past decade nominal lending rates have averaged little more than 6 percent even as the economy grew nominally by 14 to 15 percent annually. Even if we accept that annual GDP growth has been overstated by 2 or 3 percentage points, this still implies that borrowers received a hugely disproportionate share of growth at the expense of depositors. With lending rates 4 to 7 percentage points below adjusted GDP growth rates, and with household deposits (including farm deposits) equal to anywhere from 80 percent to 100 percent of GDP, the total transfer from households to state-owned enterprises, infrastructure investors, and other favored institutions amounts to anywhere from 3 percent to 8 percent of GDP annually.

In addition, in China, as in many of the countries that followed the Asian development model, not only have interest rates been set extremely low, but the minimum spread between the deposit rate and the lending rate is set very high, thereby guaranteeing the banks a large, and very safe, profit. This also comes at the expense of depositors. Using the same methodology as above, we can estimate the additional transfers to be roughly equal 1 percent of GDP. In a country where household income accounts for approximately 50 percent of GDP, these combined interest-rate-related transfers, of 4 to 9 percent of GDP, represent a very high hidden tax on households.
Depositors, however, cannot opt out. There are significant restrictions on their ability to take capital out of the country, and for the most part only the very rich can exploit these opportunities. Nor are there many domestic investment opportunities. Local stock and bond markets are rudimentary, highly speculative, and rife with insider activity—which effectively transfers profits from noninsiders to insiders while leaving the former with the full risk.

There are few other legal and safe alternatives to the banking system. The most common alternatives include real estate and the so-called informal banking sector, both of which generally have very high transaction costs and limited liquidity, so neither is a useful investment alternative for depositors with limited means or who may need to be able to access their savings quickly.

Depositors, in other words, have little choice but to accept very low deposit rates on their savings, which are then transferred through the banking system to banks and borrowers who benefit from these very low rates. Very low lending and deposit rates create a powerful mechanism for using household savings to boost growth by heavily subsidizing the cost of capital.

And remember yet again the impact this hidden tax on savings has on the relationship between GDP growth and household income growth. By lowering borrowing costs substantially, it encourages investment primarily in real estate development, infrastructure building, and of course manufacturing capacity (in China there is very little consumer financing).

But by reducing the amount of interest income depositors receive, it reduces the overall income they should be earning, and this is especially noticeable in a country where savings are so high and income so low as a share of GDP. This is certainly a powerful mechanism for increasing the gap between what a country produces and what it consumes. It also forces up the savings rate dramatically.

As an aside, the resulting low, or even negative, cost of capital for Chinese borrowers explains the seeming paradox of China’s capital-intensive, rather than labor-intensive, growth. Ask most people what China’s comparative advantage is, and they are likely to say that it is the huge pool of cheap and disciplined labor. But in fact this doesn’t seem to be reflected in the econo-
omy. If China's comparative advantage were cheap labor, we would expect its growth to be heavily labor intensive as businesses loaded up on the most efficient input.

But China's growth is actually heavily capital intensive. It is in fact among the most capital intensive in the world and far more so than any other developing country—even countries that are far richer and with far higher wage levels. Chinese businesses behave, in other words, not as if labor were the cheapest input they have but rather as if capital were the cheapest input. They are right. Labor may be cheap, but capital is free. It may even have a negative cost.

**Paying for Subsidies**

All three of these mechanisms do the same thing, albeit by distributing the costs and benefits in different ways to different groups among households and producers. They effectively tax household income and use the proceeds to subsidize producers, infrastructure investors, real estate developers, local and provincial borrowers, central government borrowers—in fact anyone who has access to bank lending, who employs workers, or who manufactures tradable goods, whether or not they actually export them.

In principle these mechanisms are no different from mechanisms used by the Brazilians during their "miracle" years. Brasilia heavily taxed household income and used the proceeds to promote industrialization and growth. Beijing does the same thing, but the taxes are hidden. The only real difference is that after 1975–76, when domestic borrowing capacity had become constrained, Brazil turned to external financing—subsidized by government guarantees—to fund investment, and so the impact of net foreign capital inflows meant that Brazil exported a portion of its domestic demand through a current account deficit—which perhaps accounts for the slowdown in growth relative to the early miracle years.

Besides the ones we have discussed, there are many other such hidden taxes in China. To repeat from an earlier chapter, environmental degradation,
a serious problem with China's growth model, is an important transfer of income from households to businesses. Likewise energy and water subsidies (including the cost of building facilities), the deterioration in the social safety net once provided by work units, subsidized land sales, ease of eminent domain expropriations, and so on are all forms of tax and subsidy.

Not surprisingly, these enormous transfers have made it very profitable for governments, businesses, and real estate developers to invest in infrastructure and productive capacity, even if the real returns on the projects did not justify the costs. In so doing they ignited an investment boom.

The result of this enormously successful model is so much investment-driven and employment-generating growth that even with massive transfers from households, household income has nonetheless surged. In China, for the past decade, as the country was clocking in growth rates of 10–11 percent annually, household income, and with it household consumption, grew 7–9 percent annually.

In a sense it seems like a free lunch. Household income is taxed heavily in order to generate tremendous growth. This growth causes employment to surge, and as workers move from subsistence living in rural China to the factories and development sites of the cities, their income surges. So rapidly does household income grow that even after the huge hidden taxes are deducted the wealth and ability to consume of the average Chinese grows at a pace that is the envy of world. So why not continue this growth model forever?

In fact there are very strong arguments in favor of versions of this growth model followed by Brazil, China, and many others. Alexander Gerschenkron, the Ukrainian-born American economic historian, posited in the 1950s and 1960s the concept of "backwardness," and argued that the more backward an economy was at any point in time—with relatively low manufacturing capacity and infrastructure, and perhaps higher levels of social capital—the more growth could be generated under conditions in which consumption would be constrained in favor of investment and the savings rate forced up. He argued that because of failures in the private financial sector to identify investments with positive externalities, there was likely to be, and ought to be, a greater reliance on state-directed banks to allocate capital.
In a 2003 article Columbia University economist Albert Fishlow further elucidated Gerschenkron's position:

1. Relative backwardness creates a tension between the promise of economic development, as achieved elsewhere, and the continuity of stagnation. Such a tension takes political form and motivates institutional innovation, whose product becomes appropriate substitution for the absent preconditions for growth.

2. The greater the degree of backwardness, the more intervention is required in the market economy to channel capital and entrepreneurial leadership to nascent industries, also the more coercive and comprehensive are the measures required to reduce domestic consumption and allow national saving.

3. The more backward the economy, the more likely are a series of additional characteristics: an emphasis upon domestic production of producers' goods rather than consumers' goods; the use of capital-intensive rather than labor-intensive methods of production; emergence of larger-scale production units at both the firm level as well as the individual plant level; and dependence upon borrowed, advanced technology rather than use of indigenous techniques.

4. The more backward the country, the less likely the agricultural sector is to provide a growing market to industry, and the more dependent industry is upon growing productivity and interindustrial sales for its expansion. Such unbalanced growth is frequently made feasible through state participation.7

**Limits to Backwardness**

This sounds a lot like the Chinese growth model. In fact countries undergoing the process described by Gerschenkron were able to generate fairly substantial increases in wealth for long periods of time—as clearly happened in China, at least during the first fifteen or twenty years since the reforms of 1978. But the case of China, and every other case of an investment-driven
growth miracle, suggests that the model cannot be sustained because there are at least two constraints. The first has to do with the constraint on debt-financed investment and the second with the constraint on the external account, and one or both constraints have always eventually derailed the growth model.

To address the first constraint, in the early stages for most countries that have followed the investment-driven growth model, when investment is low, the diversion of household wealth into investment in capacity and infrastructure is likely to be economically productive. After all, when capital stock per person is almost nonexistent, almost any increase in capital stock is likely to drive worker productivity higher. When you have no roads, even a simple dirt road will sharply increase the value of local labor.

The longer heavily subsidized investment continues, however, the more likely that cheap capital and socialized credit risk will fund economically wasteful projects. Dirt roads quickly become paved roads. Paved roads become highways. And highways become superhighways with eight lanes in either direction. The decision to upgrade is politically easy to make because each new venture generates local employment, rapid economic growth in the short term, and opportunities for fraud and what economists politely call rent-seeking behavior, while the costs are spread through the entire country through the banking system and over the many years during which the debt is repaid (and most debt is rolled over continuously).

It also seems easy to justify intellectually the infrastructure upgrades. After all, rich countries have far more capital stock per person than poor countries, and those investments were presumably economically justified, so, according to this way of thinking, it will take decades of continual upgrading before China comes close to overbuilding.

The problem with this reasoning of course is that it ignores the economic reason for upgrading capital stock and assumes that capital and infrastructure have the same value everywhere in the world. They don’t. Worker productivity and wages are so much lower in China than in the developed world. This means that the economic value of infrastructure in China, which
is based primarily on the value of wages it saves, is a fraction of the value of identical infrastructure in the developed world. It makes no economic sense, in other words, for China to have levels of infrastructure and capital stock anywhere near those of much richer countries because this would represent wasted resources—like exchanging cheap labor for much more expensive labor-saving devices.

Of course because risk is socialized—that is, all borrowing is implicitly or explicitly guaranteed by the state—no one needs to ask whether or not the locals can use the highway and whether the economic wealth created is enough to repay the cost. The system creates an acute form of what is sometimes called the “commonwealth” problem. The benefits of investment accrue over the immediate future and within the jurisdiction of the local leader who makes the investment decision.

The costs, however, are spread widely through the national banking system and over many years, during which time, presumably, the leader responsible for the investment will have been promoted to another post in another jurisdiction. With very low interest rates and other subsidies making it hard to determine whether investments actually reduce value or create it, the commonwealth problem ensures that further investment in infrastructure is always encouraged.

The problem of overinvestment is not just an infrastructure problem. It occurs just as easily in manufacturing. When manufacturers can borrow money at such a low rate that they effectively force most of the borrowing cost onto household depositors, they don’t need to create economic value equal to or greater than the cost of the investment. Even factories that systematically destroy value can show high profits, and there is substantial evidence to suggest that the state-owned sector in the aggregate has probably been a massive value destroyer for most if not all the past decade, but is nonetheless profitable thanks to household subsidies.

At some point, in other words, rather than creating wealth, capital users begin to destroy wealth, but nonetheless show profits by passing more than 100 percent of the losses onto households. The very cheap capital especially
means that a very significant portion of the cost—as much as 20–40 percent of the total amount of the loan—is forced onto depositors just in the form of low interest rates. This is effectively a form of debt forgiveness granted, unknowingly, by depositors.

Under these circumstances it would take heroic levels of restraint and understanding for investors not to engage in value-destroying activity. This is why countries following the investment-driven growth model—like Germany in the 1930s, the Soviet Union in the 1950s and 1960s, Brazil in the 1960s and 1970s, Japan in the 1980s, and many other smaller countries—have always overinvested for many years, leading, in every case, either to a debt crisis or a “lost decade” of surging debt and low growth.

The Trade Impact

The second constraint is that policies that force households to subsidize growth are likely to generate much faster growth in production than in consumption—growth in household consumption being largely a function of household income growth. In that case even with high investment levels, large and growing trade surpluses are needed to absorb the balance because, as quickly as it is rising, the investment share of GDP still cannot increase quickly enough to absorb the decline in the consumption share.

This is what happened in China in the past decade until the crisis in 2007–8, after which Beijing had to engineer an extraordinary additional surge in investment in order to counteract the contraction in the current account surplus. As Chinese manufacturers created rapidly expanding amounts of goods, the transfers from the household sector needed to subsidize this rapid expansion in manufacturing left them unable to purchase a constant share of the goods being produced. The result was that China needed to export a growing share of what it produced, and this is exactly what it did, especially after 2003.

As long as the rest of the world—primarily the United States and the trade deficit countries of Europe and Latin America—have been able to
absorb China's rising trade surplus, the fact that domestic households absorbed a declining share of Chinese production didn't matter much. A surge in American and European consumer financing allowed those countries to experience consumption growth that exceeded the growth in their own manufacture of goods and services.

But by 2007 China's trade surplus as a share of global GDP had become the highest recorded in one hundred years, perhaps ever, and the rest of the world found it increasing difficult to absorb it. To make matters worse, the global financial crisis sharply reduced the ability and willingness of other countries even to maintain current trade deficits, and as we will see this downward pressure on China's current account surplus is likely to continue.

So China has hit both constraints—capital is wasted, perhaps on an unprecedented scale, and the world is finding it increasingly difficult to absorb excess Chinese capacity—and in fact may have hit the former constraint a decade or more ago. For all its past success China now needs urgently to abandon the development model because debt is rising furiously and at an unsustainable pace, and once China reaches its debt capacity limits, perhaps in four or five years, growth will come crashing down.

The sooner it abandons the model the less painful the adjustment, but it will be difficult under any scenario, even with an immediate and sizable adjustment. China must raise wages, interest rates, and the value of the currency in order to reverse the flow of wealth from the household sector to the state and corporate sector, but if it does so quickly it could cause severe financial distress to businesses and projects heavily dependent on subsidized costs, and the resulting surge in unemployment could actually cause consumption to decline just as Chinese competitiveness abroad deteriorates.

If it does so slowly, on the other hand, China will need continued accommodation from the external sector, but it is not at all clear that the rest of the world, most importantly the United States and the trade deficit countries of Europe, will allow their trade deficits to stay high—in fact peripheral Europe has no choice but to see its deficits contract. What's more, a slow adjustment means the imbalances and debt will continue to get worse for several years
before they get better, and during that time China will have to pile on ever more wasted investment to keep growth manageable.

A Lost Decade?

The historical precedents for this kind of adjustment are not encouraging, and the adjustment China needs to make dwarfs those of its predecessors. Like it or not, China must change its growth model. Until it does so it will be excessively vulnerable to changes in the trade surplus or in domestic investment.

So how will China adjust? Almost certainly it will adjust with much lower growth rates driven by a collapse in investment growth. Mahatma Gandhi famously complained that speed is irrelevant if you are going in the wrong direction, and clearly China is racing forward, but in the wrong direction. Until recently it was hard to find economists who expected annual Chinese GDP growth to drop much below 8–9 percent over the next decade, but the extent of the overinvestment problem has finally forced even the greatest optimists to reconsider.

As China fitfully tries to rebalance its economy, a small but rising number of Chinese economists are now beginning to predict sharply lower annual growth rates of 6 to 7 percent over the next few years. But the arithmetic of adjustment suggests growth is likely to be even lower, perhaps half that level.

How can China rebalance away from investment and toward domestic consumption as the main engine of growth? Only with great difficulty. Chinese households consume only about 34 percent of GDP, not much above half the global average and far less than the rate in any other country. It bears repeating that such a large domestic imbalance has no historical precedent.

Over the next ten years policymakers have said that they will try to raise consumption to 50 percent of GDP. Although this represents a substantial adjustment for China, it is worth remembering that 50 percent will still leave China with by far the lowest consumption rate of any major economy, and given the need for an equal and opposite adjustment by the low-savings economies of the rest of the world, it is not at all obvious that the world will
be able to accommodate even this limited improvement in the imbalance in the Chinese economy. The world is desperate for demand, and foreigners may be unwilling to accommodate such a large gap between what China produces and what it consumes.

But even achieving this goal will be hard because it requires that household consumption grow 4 percentage points faster than GDP. To raise consumption from 34 percent of GDP to 50 percent of GDP in ten years, in other words, consumption growth must outpace GDP growth by 4 full percentage points every single year of the decade. If China’s GDP grows at 10 percent annually for the next decade, for example, we would need consumption to grow by 14 percent annually in order to achieve the target.

Can China do it? In the past decade, Chinese household consumption has grown by 7 percent to 8 percent annually, while GDP has grown at an astonishing 10 percent to 11 percent. If one expects Chinese GDP to grow by 6 percent to 7 percent on average over the next decade, as increasingly pessimistic policymakers and advisors in Beijing are suggesting, Chinese household consumption would have to surge by 10 percent to 11 percent annually just to permit a rebalancing to 50 percent of GDP in ten years.

Such consumption growth is unlikely because powerful structural factors work against it. First and most obviously, the global environment is likely to be much less accommodating over the next decade than it was in the previous decade. Second, the Chinese growth model, remember, transfers income from households to the corporate and state sector, mainly in the form of artificially low interest rates, in order to generate such rapid growth. Low interest rates in particular sharply reduce borrowing costs for the state-owned companies that funnel this easy money into mega-investments.

The easy financing also gooses banks’ profit margins and allows them to resolve bad loans with ease. If we see a surge in nonperforming loans, which almost everyone expects, low interest rates will be the prime mechanism for recapitalizing the banks and permitting insolvent borrowers to “grow” their way back into solvency.11

But of course this cheap borrowing will continue to come at the expense of household depositors. Low yields on deposits will force them to sacrifice consumption in order to raise savings to some target level. This will result in
a continued downward pressure on consumption, making it hard for consumption growth in the next decade to outpace consumption growth in the past decade.

**Can China Manage the Transition More Efficiently?**

So what kind of GDP growth rates can we expect for China over the next decade? Even if consumption manages to keep growing at the same rate it has during the past decade, when Chinese and global conditions were buoyant and debt levels much lower, China’s growth must slow to 3–4 percent at best to achieve real rebalancing. This is the impact, in other words, of the required reduction in investment, which will have to be sudden and sharp.

In a less optimistic scenario, consumption growth will slow down to less than what it was last decade—perhaps because of slower GDP growth—making rebalancing even harder. In that case for China to achieve real rebalancing, GDP growth rates will be even lower than 3 to 4 percent.

Will slower growth be a disaster for China, and will it lead to social instability? Not necessarily. If the rebalancing is well managed, by definition household income and consumption will grow faster than GDP, and so the lost decade of growth will not be as painful for the household sector as one might imagine. For example, one can easily posit a case in which China’s GDP grows by 3 percent annually, Chinese household income grows at 5 percent, and consumption at 5 or 6 percent. In that case Chinese households will continue to feel better off and to have improving economic prospects.

But by definition if household income grows faster that GDP, there must implicitly be a transfer of resources from the state to the household sector. For much of the past three decades we have seen the opposite, so the household share of the rapidly growing pie has contracted while the state share has expanded. This must be reversed.

There is a “good” way to manage and speed up the process, and that is through some form of direct or indirect privatization of state assets. This would involve the government’s recapitalizing the banks with state assets
(because otherwise losses must be subsidized by households) and transferring resources from the state sector to the household sector in other ways. Remember that the key to raising the consumption share of GDP is to raise the household income share of GDP.

Transferring state assets to the private sector is, however, easier to say than to do, and there will be significant political constraints and resistance from vested interests that will make this transfer very difficult, as we saw at the beginning of this chapter. If Beijing is unable for domestic political or other reasons to accommodate direct transfers of state assets, with everything this must entail of corporate governance reform, there is a second, less "good" way for the transfer of state assets to the household and private sector, which is the way Japan stumbled upon after the 1990 crisis. This is simply to let the state continue absorbing private debt.

Government debt levels soaring faster than government assets, as they did in Japan after 1990, is effectively a transfer of wealth from the state sector to the private sector. In Japan after 1990 this allowed continued growth in Japanese household income and consumption (both of which sharply outpaced the less than 1 percent GDP growth Japan averaged after 1990).

State absorption of debt in China can have the same impact. This is a "less good" approach than the privatization approach because although it is politically much easier (no important sector or family actually has to give up control of state sector industries to be privatized), the problem with it, as Japan amply demonstrates, is that debt levels will soar and themselves become a huge constraint to future growth and reform.

Some More Misconceptions

The picture is not especially bright for GDP growth, but it is not especially gloomy for household income growth or social stability. China and the world should prepare for a world in which average Chinese GDP growth over the next decade is likely to be less than 3 or 4 percent annually—heavily front-loaded, with more now and less later. Along with it Chinese government
debt will soar in much the same way government debt did in Japan after 1990. Excluding a radical political transformation in which much of the state sector is turned over in a direct and meaningful way to the private sector, this is the only scenario under which China can meaningfully rebalance.

Before ending this chapter on China, I want to return to the article that I discussed at the end of chapter 3. In the article the author argued that the foreign exchange value of the renminbi does not matter to China’s trade balance. This argument is widely made and widely believed (the author even calls them “home truths”) but, as I hope to have demonstrated, wholly mistaken. The article made two other claims that are very common and also seriously mistaken. I show why they are mistaken in the next chapter as well as in chapters 6 and 7, but because they are so widespread—and seem at first glance to be very plausible—it is worth considering them.

**American consumers have benefitted enormously from Chinese production efficiency.** While overall consumer prices in the U.S. have risen by 42 per cent over the last 15 years, prices of durable goods have fallen by 14 per cent. Average toy prices have come down 57 per cent. But have the people who made this possible ever received a word of thanks from the beneficiaries? Cup your hands to your ears. Listen hard.

**Profligate American consumers who scorn savings rely on China to make the necessary investments in their country.** All the money that goes to China to pay for consumer rubbish flows right back in again as investment to make up for fiscal and trade deficits. This helps keeps interest rates down and the U.S. dollar strong.

It is true of course that American consumers have benefitted from Chinese subsidies, but this is hardly a good thing in a country suffering from over-consumption. The reason no thanks have been offered is because this benefit comes with a cost. The dispute over trade is about employment and debt, not about each country helping the other consume, and to ignore them misses the point.

We explore why this is the case in chapters 5 and 7, but for the moment it is probably enough to point out that if China’s subsidizing of American con-
sumption is such an obviously good thing for Americans, it is puzzling why American attempts to reverse the process and subsidize Chinese consumption, by getting China to raise the value of the renminbi, are so strongly resisted by Beijing. After all, given the difference in wealth between Chinese and American consumers, it would be hard to argue that Americans deserve the favor more than the Chinese.

As for the second point—that the United States benefits not just from importing Chinese goods cheaply but also from importing Chinese savings—this is also wrong, and wrong in what should be a very obvious way. Exporting savings is not an act of generosity. To see why, please read on.