CHINA'S MACROECONOMIC ADJUSTMENT PROBLEM

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China is facing a severe macroeconomic adjustment problem. In order to transition smoothly to a self-sustaining balanced growth path at full employment, China must reduce its excessive dependence on investment as the main source of aggregate demand supporting full employment and price stability. The heart of China's problem is its exceptionally low share of private consumption in GDP—36% as of 2014.[1] To sustain full employment, China has maintained a very high share of investment—rising from 40% of GDP in 2006 to 46% in 2014—estimated to exceed a level consistent with fundamentals by as much as 10 percentage points of GDP.[2]

To sustain investment, local governments and banks have directed loanable funds to politically-favored, state-owned and other "well-connected" enterprises in heavy industry. However, productive investment opportunities in heavy industry (factories, housing, and infrastructure) are being used up and overinvestment is wasteful because it yields low rates of return due to underutilization and depreciation. Many local government entities and well-connected firms are today saddled with precarious debt burdens, having borrowed heavily to finance investment to sustain employment first when net exports collapsed in the wake of the 2008 financial crisis and later when net exports contracted as dollar appreciation dragged the trade-weighted renminbi exchange rate higher.[3]

To buy time, financial authorities have been trying with limited success to encourage banks to channel domestic savings to "unconnected" smaller businesses promising higher returns to investment; this, to offset the incentive for banks to favor loans to well-connected enterprises against ostensibly better collateral.

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[1] IMF Country Report No. 15/234, People's Republic of China, August 2015, page 51
[2] Lee, Syed, and Xueyan "Is China Over-Investing and Does It Matter?" IMF Working Paper, November 2012, page 12
[3] IMF, People's Republic of China, August 2015, pages 50 and 52

Likewise, the authorities have been trying to improve credit availability to households to stimulate consumption.

Ultimately, however, Chinese authorities need to encourage a larger share of consumption out of current income by making the Chinese public more confident of lifetime income. The public must be made confident of political and social stability, job security, the means of wealth accumulation, health care and retirement income in old age.

To maintain confidence in the future, the Communist Party knows that it must first maintain the public's confidence in itself. Yet, the Party is increasingly concerned about being regarded as corrupt and manipulative. For example, recall the Shanghai equity price interventions, the recent chemical plant explosion, food safety scandals, and the school construction earthquake scandal.

The problem is this: As China transitions into a thoroughly modern economy, production, wealth management, and government services all become increasingly specialized. Complexity vastly increases the scope for mismanagement and the opportunity for corruption and manipulation in the Communist Party's stewardship of the economy. It becomes increasingly costly for the Party to enforce good behavior from the top down through the Party hierarchy. To ensure the reliable delivery of specialized goods and services, China has little choice but to rely on arms-length business relationships disciplined by competition and contractual obligations under the rule of law enforced by legal institutions independent of politics.

Recognizing the problem, China is trying to build credible stand-alone legal institutions. By all accounts this is going slowly. The reason is that a stand-alone rule of law would deprive Party members of the "rents" they currently obtain from providing "protection" of business interests, and from the opportunity to engage in corrupt and manipulative activities. China likes to compare its model of economic development to that of Singapore; but Singapore was hugely advantaged by the legal institutions and the rule of law that it inherited from Britain.

It is far from clear that the Party will create a stand-alone rule of law in China any time soon, if ever. Left unchecked—pay for protection, bribery, and manipulation will become more pervasive, increasingly onerous, dampen expected future economic activity, and drive economic activity underground. The underground economy, in turn, will impede the government's capacity to raise tax revenue to fund health care, social security, and other transfers to provide future financial security.

For all these reasons, it seems fair to say that the Communist Party will have difficulty making the public sufficiently confident of future income prospects to encourage more consumption out of current income. The fact that China's growth rate has been falling of late makes that outcome even less likely. The IMF expects China's economy to grow by only 6.8% in 2015 and 6.3% in 2016, far below the 10% average annual growth rate from 2000 to 2010.

Whether or not China succeeds in raising its consumption share of GDP, it needs to cut back its investment share sometime soon. Delaying the inevitable—wasting resources, incurring balance sheet losses, and building up excess capital stock—would in itself undermine confidence in the Communist Party's stewardship of the economy. And workers anticipating layoffs in the production of heavy investment goods would begin to cut their consumption beforehand anyway.

Unless consumption can pick up the slack in a timely manner, the requisite contraction of investment would precipitate a recession. The People's Bank of China has already cut interest rates five times since November 2014 and could ease monetary policy further to cushion employment and guard against deflation. But the adjustment process promises to be difficult in any case.

To consume more out of current income the Chinese public must believe that China will transition smoothly to a self-sustaining balanced growth path in which household incomes continue to rise. Unfortunately, just the reverse seems to be happening—private consumption actually fell to 36% from around 48% of GDP in 2000, suggesting that the Chinese have been saving more against a more uncertain future.