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Complex Structural Changes in China and the Global Economy

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This article is a guest contribution by A. Michael Spence, PIMCO, Newport Beach, California.

In 2008 PIMCO had the privilege of entering into a special consulting arrangement with Dr. Michael Spence, a Nobel Laureate and professor emeritus of management in the Graduate School of Business at Stanford University. He has dedicated his career and intellect to deepening the understanding of economics and repeatedly received recognition for his contributions to the field. In his capacity as special consultant to PIMCO, he has brought his knowledge and experience into the core of our investment process.

Introduction

Chinese policymakers are now engaged in a debate that will lead to the creation of the 12th five-year plan – a document whose name is misleading, a leftover from the days of central planning. It is now more a vision of how the economy will grow. From that general conception follows a set of economic and social policy priorities that are widely shared and guide budgets and policy setting. This particular five-year plan will go into effect in 2011 just before a new leadership team in 2012. The debate is far-ranging but there is a surprising lack of fundamental disagreement about the need to radically change the growth model.

The time horizons and clarity of objectives stand in contrast to the state of policy debate in many of the advanced countries – on issues such as deficits, the speed of exit on the fiscal and monetary side, and the future basis of growth and competitiveness.

Having a shared understanding of the future drivers of growth and the required structural underpinnings makes the policy formation process much more effective and coherent.

The New Normal

The external global context is shifting rapidly and possibly adversely for the major developing countries. Until relatively recently there was a widespread view that the [recession](#) ^[3] would be deep and probably long in duration and slow in recovery, but it was still viewed as a cyclical mean-reverting event. That view is being displaced by a recognition that the [global economy](#) ^[4] and some of its major parts are undergoing a permanent structural shift.

Balance sheet restoration in the household sector cannot be accelerated much and will just take time. Beyond that, risk aversion and the non-recurrence (at least in the near term) of another asset bubble may mean higher savings more permanently. Unemployment will likely decline stubbornly slowly, though generous and extended unemployment insurance (about to be enacted) should help restore consumption.

Deleveraging on the private sector side is proceeding in parallel with leveraging up on the public sector side. There are no widely understood or accepted plans for the restoration of fiscal balance on a five- to 10-year time horizon, and given the political situation it is unclear that such a plan can be produced, one that is believable. That creates uncertainty, and potential interest rate and exchange rate volatility.

This configuration is what is called the New Normal. It is characterized by slower growth, an extended shortfall in global aggregate demand, an environment in which the protectionist incentives are large and where risk and uncertainty dominate. Central [banks](#) ^[5] and governments face difficult choices about fragility, exits and excess liquidity risks, sovereign debt, and longer-term sources for growth. If you ask in America now what is the country's

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probable longer-term basis of comparative advantage, you probably will not find an emerging consensus.

The New Normal is not something just to be forecasted. It is a work in progress. On the international side, how that will come out in rebalancing global demand, financial re-regulation and a number of other areas, is as yet not determined. It will depend in part on the untested effectiveness of the G-20. Given the substantial domestic challenges and focus in advanced countries, and the adverse incentives for coordination in a low growth environment, it is a difficult moment to be optimistic on this front. But one can always hope that one's pessimism is misplaced.

It is an extraordinarily difficult environment for investors. Managing risk (associated with growth, fragility, currencies, sovereign debt) and asset allocation dynamically is the difficult challenge.

On a secular three- to five-year horizon, the New Normal is the global context in which the major developing countries will have to sustain growth and formulate policy. Of these economies, China ^[6] is the one with the largest impact on the performance of the global economy.

China's Complex Structural Challenges China's Size and Global Impact

China has come to a point where its size and impact globally are large. And that has occurred at a much lower level of income than is true of any of its predecessors. This is the result of sheer size and the high-speed growth of the past 30 years. Japan is the closest analogue in the postwar period but even Japan became systemically important at a much higher per capita income level. Policy in China will have to be set with a delicate balancing act between domestic growth and development and distributional challenges on the one hand, and a recognition that factoring in the global impacts is in China's longer-term interest. In this area, there is not much useful historical experience to look to for guidance. Thoughtful expert international commentary is that it is in the country's interest to tackle this balancing challenge head-on. The rest of the world's interest in China may seem meddling, but actually it is a recognition of the country's systemic importance and its role in architecting an evolving global economic order.

And the large developing countries need to understand better than they currently do that their growing size and presence in trade in goods and prominently services is forcing uncomfortable structural change in the advanced countries as well. All the parts are in motion.

The Middle Income Transition

Though China is a large and complex economy with significant variation across regions, in general, the high growth part of the economy is entering the middle income transition, which involves the evolving microeconomic structure and composition of the economy. It is a difficult transition based on international experience and historical evidence. Relatively few countries have sustained high growth in this process (Japan, Korea, Singapore and within China, Taiwan and Hong Kong). Most others (in Asia, the Middle East and Latin America) have experienced a significant growth slowdown or a pause or even an extended stalling out.

In the middle income transition, the domestic economy becomes a more powerful engine of growth, the middle class grows and their purchasing behavior helps guide the economy's structural evolution, partially displacing foreign demand in this role. Economic diversification continues and accelerates in both the domestic and export sectors. Data on the composition of the economy indicate that this process is well underway in China.

The destruction half of Schumpeter's creative destruction gains prominence as the labor-intensive process manufacturing industries lose competitiveness because of rising incomes and, in China's case, move inland, along the coast, offshore and eventually die off. They are replaced by higher value added activities that are capital, human capital and knowledge intensive. The service sector becomes larger especially in urban areas, and may become a significant source of incremental productive employment for the continuing rural to urban migration, replacing in part the declining component of the export sector. Markets ^[7] and investment guide this evolution, supported by public sector investment in education, research

and technology. The knowledge base of the economy deepens and the balance between importing and creating technology shifts in favor of the latter.

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there are four
superb answers.

Financial sector development becomes important in providing a growing set of savings options and in channeling risk capital to potentially high return destinations associated with entrepreneurial activity. The investment system needs to be reconfigured so that less investment occurs in high liquidity, low marginal returns sectors, and more is directed by the financial system to low liquidity but high marginal returns areas. Industrial policy remains important but becomes more horizontal and agnostic about sector-specific development and aims rather to create intangible assets and soft infrastructure that support the market's natural dynamism and diversification.

Why has this transition proved difficult in many countries, including high growth cases?

In part it is because it is difficult to abandon a formula that worked and was spectacularly successful for several decades. There are policy instruments that can be used to preserve the old order but they can lead eventually to a stagnation in productivity and hence income growth. Developing countries fundamentally grow by continuously changing what the economy does and not mainly by doing what was better done five or ten years ago. High-speed growth and structural change can be uncomfortable and anxiety-producing. The supporting social service and insurance systems are crucial in protecting people, enabling labor mobility, managing distributional outcomes and maintaining support for the growth-oriented policies. In their absence, resistance to growth and change often develop. Social policy is not an orthogonal policy add-on – nice to have but inessential to growth. Rather it is a centrally important part of successful growth strategy.

There are also within many countries politically powerful forces that have a vested interest in the status quo. Those interests are sometimes powerful enough to shift the policy priorities in the direction of protecting those interests. But it doesn't last indefinitely. The longer-term costs are too high.

Restructuring the Demand Side of the Economy

In China, household income has fallen to less than 60% of GDP and savings out of disposable income is at 30%. By most estimates this puts consumption at about 40% of GDP. The middle class is too small given the average level of income. The problem is that not enough income is in the hands of consumers. Where is it? It is in profits in the private and state-owned enterprise sector and with the government.

Both of these sectors tend to invest heavily and are fully funded by retained earnings and tax revenues to do so. The result is a saving and investing machine. That plus exports have been the primary drivers of growth historically. But that needs to change.

In a global economic setting humbled by a crisis and extended lower growth and a shortfall in aggregate demand, for China the wisdom of deriving as much growth from the domestic market is clear. This requires integration and removal of remaining policy-imposed barriers to internal trade so that the market is integrated. But it also involves a shift in the composition of domestic aggregate demand toward the consumer. The economy and aggregate demand in earlier years, when domestic demand was relatively small, was driven by foreign demand (the export sector) and by investment, much of it public. What is needed now is an evolution in the direction of rising consumer demand as the principal guide to the microeconomic structural evolution of the economy. In an economy that is arguably on the boundary of overheating, the issue is certainly not total aggregate demand but rather its composition. That is what should be managed over time.

It has been noted correctly that labor supply conditions may cause a continuing drag on wage income growth for a few years, especially at the lower end of the wage distribution. Government consumption on much-needed social services and insurance may be needed to fill in the gap. And that in turn may have a positive impact on reducing precautionary saving in the household sector. But eventually household disposable income has to rise through a combination of market forces and a set of policies that redirect income via the tax system, the deployment of state-owned enterprises' (SOE) retained earnings and dividends, and the provision of social services and insurance.

Let me conclude this section by observing that until 2004, current account surpluses and deficits in China were quite modest, on the order of 3% of GDP or less. Then investment rose and savings accelerated even more, leading to a current account surplus in 2007 of about 10% of GDP. The lion's share of that increase came from the corporate sector investing retained earnings with a lesser but significant contribution from government (infrastructure). The crisis response extended the pattern for understandable reasons. But the time has come to set in motion the reversal of that pattern. It will likely take several years. But as an underpinning of future growth, it is an essential piece.

Rebalancing and Restoring Global Demand

China and the rest of the world have a shared interest in moving toward restoring and rebalancing global demand. This involves complex structural change in many countries and will take time. That is not always widely understood. Exports in China are shifting rapidly in composition, as they should, but in a slow growth external global environment, at China's size they cannot grow beyond a certain point without large increments in China's market share. And that would provoke an adverse response and potentially puts China at odds with other G-20 countries. Remember that in the early stages of growth, poorer countries have the potential to grow very fast and take minuscule amounts of global market share. They typically do not turn the terms of trade against themselves. China used to have that luxury but it does not anymore.

China's interests and the global economy's interests are in fact quite closely aligned in a very important respect. It is the elimination of the excess savings and the current account surplus in a way that does not impair China's growth. It is in everyone's interest, and is entirely consistent with making more use of the domestic economy as an engine of growth. It will help restore global growth and as a side effect, reduce the incentives to use protectionist measures to gain or at least not lose market share. In a very low growth environment, market share and growth tend to be much more highly correlated than in a high growth environment.

Similar slightly modified statements apply to other major surplus countries who have similar roles to play. The exceptions are the oil- and gas-rich countries that cannot possibly consume or domestically invest all of the revenues and hence pretty much have to run surpluses and invest the proceeds abroad.

Given this alignment of interests, it should be possible to converge on a coordinated plan to rebalance global demand over the next five years. But there are obstacles.

It is not well understood externally that both the surplus and China's economic growth are important. Much external commentary focuses on the exchange rate, which if used by itself to try to reduce the surplus would probably fail – not only to reduce the surplus, as the savings are deeply structurally embedded. It would also almost certainly slow growth. There

is much talking at cross purposes, though recently the conversation appears to have taken a positive turn. There is also a tendency in the political arenas in many countries to view the process as a zero sum game in which the outcome is jobs gained or lost. This gets in the way of identifying and acting on common interests. In a zero sum game, there aren't any.

On the China side, there is much merit in a return to the pre-crisis pattern of managed appreciation of the yuan as the continuing basis of growth is solidified. Appreciation will maintain an appropriate amount of pressure for the microeconomic structural changes in the middle income transition. It might also help to diffuse the issue internationally and avoid a scenario that sets us out on a course of taking mini-steps in the direction of expanded protectionism and a reversal of the opening of the global economy.

Even if we get to a better balanced global demand over time, exchange rate management will continue to be an important component of growth strategy, especially in the current very low external interest rate environment. Reserve accumulation and inbound capital controls will need to continue for some time, creating something of a growing asset management headache.

Risk

In navigating the transition to a new growth pattern with sustained high growth, there are internal and external risks for China. Externally the advanced economies are fragile, well below potential output, domestically focused and protectionist in mood. The deep fiscal challenges in many advanced countries are daunting. According to a recent IMF study, a high fraction of the deficit increases are non-discretionary stimulus, that is, falling tax revenues and rising social insurance payments. There is growing tension between advanced countries and China that needs to be managed on all sides.

Internally, there are numerous opportunities to fall out of internal and external balance. There is the risk of staying with the old growth model for too long in response to vested interests. And there are rising social tensions associated with high variation in incomes, perceived employment opportunities and access to basic services, which could become disruptive if left unattended.

Implementation

Apart from the policy specifics, which are important but not sufficient, of overriding importance are effective implementation, rapid responses to future internal and external shocks, communication and attention to resilience.

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