

China: Rebalancing Economic Growth

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In December 2004 at the annual Central Economic Work Conference, China's top political leadership agreed to fundamentally alter the country's growth strategy by rebalancing the sources of economic growth. In place of investment and export-led development, they endorsed transitioning to a growth path that relied more on expanding domestic consumption.¹ Since 2004, China's top leadership, most notably Premier Wen Jiabao in his speeches to the annual meetings of the National People's Congress in the spring of 2006 and 2007 and at the Central Economic Work Conference in November-December 2006, have reiterated the goal of strengthening domestic consumption as a major source of economic growth.²

China's announced decision to rebalance the sources of economic growth is laudable. It increases the likelihood of China's sustaining its strong growth of recent years, achieving more rapid job creation, improving income distribution or at least slowing the pace of rising income inequality, and reducing its outsized increases in energy consumption of recent years. It also would help reduce global economic imbalances and thus lessen the risk that China would be subject to protectionist pressure, especially in Europe and the United States.

But at least through early 2007 China's policy initiatives have been relatively modest, with only a slight change in China's underlying growth dynamic. As a result, China's economic expansion remains disproportionately dependent on rising investment expenditures and an expanding trade surplus. China's external

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¹ "Central Economic Work Conference Convened in Beijing, December 3 to 5," *People's Daily*, December 6, 2004, <http://www.people.com.cn>.

² Wen Jiabao, "Report on the Work of the Government," *People's Daily*, March 14, 2006, <http://english.people.com.cn>. New China News Agency, "We must concretely grasp eight work items to do well in next year's economic work," December 1, 2006, <http://politics.people.com.cn/GB/1024/3907488.html>. Wen Jiabao, "Report on the Work of the Government," March 5, 2007.

surplus continued to balloon to a global record in 2006 and, short of a U.S. recession, seems almost certain to expand further in 2007. China also is falling short of meeting several of its key domestic economic objectives.

What Are the Sources of China's Economic Growth?

China has been the fastest growing economy in the world over almost three decades, expanding at 10 percent per year in real terms. As a result, real GDP in 2005 was about 12 times the level of 1978, when Deng Xiaoping launched China on the path of economic reform (National Bureau of Statistics of China 2006a, 24). China is now the world's fourth-largest economy and its third-largest trader and highly likely, within a year, to move up a notch in each category. Given this stunning long-term success, why would China's leadership even entertain the idea of shifting to a new growth paradigm?

In all economies the expansion of output is the sum of the growth of consumption (both private and government) plus investment plus net exports of goods and services. Expanding investment has been a major and increasingly important driver of China's growth. As shown in figure 1, investment averaged 36 percent of GDP in the first decade or so of economic reform, relatively high by the standard of developing countries generally but not in comparison with China's East Asian neighbors when their investment shares were at their highest. But since the beginning of the 1990s, China's investment rate has trended up. In 1993 and again in both 2004 and 2005, investment as a share of GDP reached 43 percent, a level well above the historic experience of China's East Asian neighbors in their high-growth periods.³ Rising investment has been fueled by a rise in the national saving rate, which reached an unprecedented 50 percent of GDP in 2005.⁴ Rising investment was particularly important in 2001–2005, when it contributed just over half of China's economic growth (National Bureau of Statistics of China 2006b, 70), an unusually high share by international standards.

The growth of both household and government consumption has been rapid in absolute terms throughout the reform period, but has lagged the underlying growth of the economy. As shown in figure 2, in the 1980s household consumption averaged slightly more than half of GDP. This share fell to an average of 46 percent in the 1990s. But after 2000, household consumption as a share of GDP fell sharply—and by 2005 accounted for only 38 percent of GDP, the lowest share of any major economy in the world.⁵ In the United States,

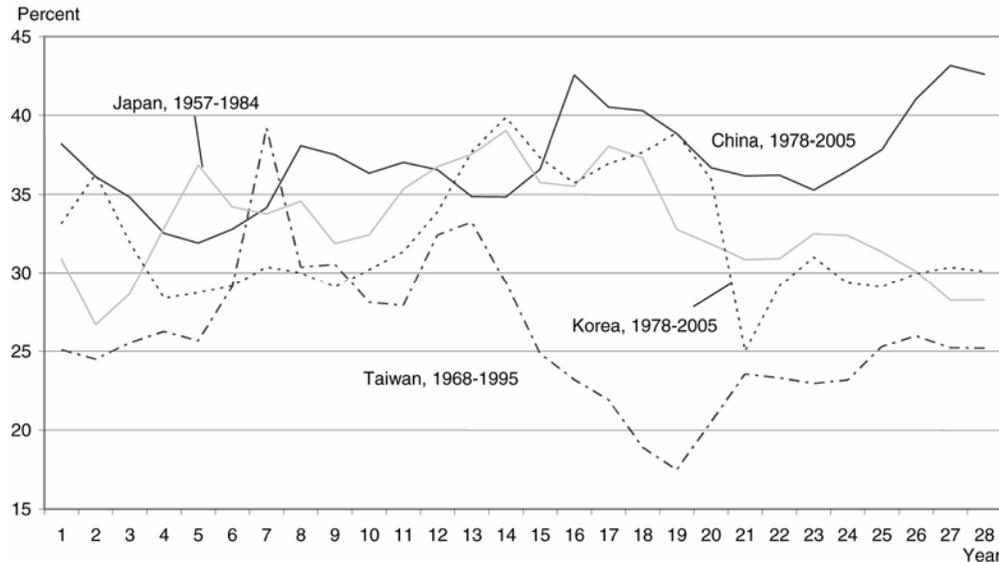
³ All of the analysis of the expenditure components of GDP (i.e., consumption, investment, and net exports) is based on the revised GDP expenditure data for the years 1978 through 2005 released by the National Bureau of Statistics of China (2006b) in late September 2006.

⁴ By definition, the national saving rate is equal to investment as a share of GDP plus the current account as a percent of GDP. In China, these were 42.6 and 7.0 percent of GDP, respectively, in 2005.

⁵ The declining share of consumption in GDP is due to both a decline in household disposable income as a share of GDP and a decline in consumption as a share of disposable income. Some analysts believe that household consumption, particularly of services, is undercounted by China's National Bureau of Statistics and thus the share of household consumption in GDP is biased

household consumption accounted for 70 percent of GDP in the same year. In the United Kingdom, the household consumption share was 60 percent. In India, it was 61 percent. Even in Japan, famous for its high household savings, household consumption in 2005 accounted for 57 percent of GDP, half again as much as the share in China (IMF).

Figure 1. Capital Formation as Percent of GDP



Note: For each country the time period is when the average rate of capital formation was the highest.
 Source: National Bureau of Statistics of China, *China Statistical Yearbook 2006*; Council for Economic Planning and Development of Republic of China, *Taiwan Statistical Data Book 1997 and 2006*; IMF, *International Financial Statistics*.

As shown in figure 3, government consumption in China as a share of GDP has been more stable, averaging around 14 percent of GDP throughout the reform period. Government consumption, however, did decline from a peak of about 16 percent of GDP in 2001 to just under 14 percent in 2005.

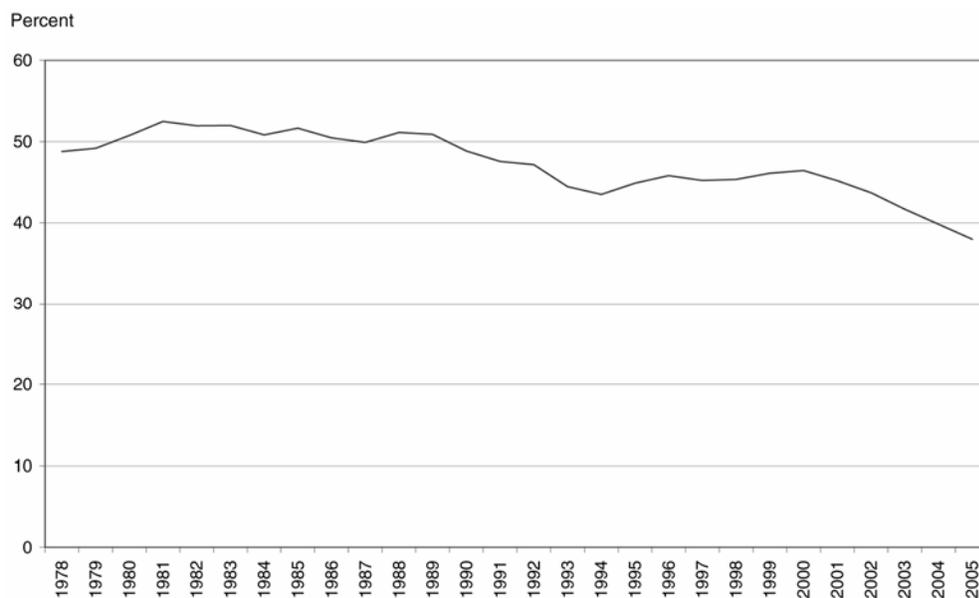
As a result of these trends in household and government consumption, the relative importance of expanding consumption growth as a source of overall economic growth during the past two decades has diminished substantially, particularly compared with that of investment. In the first half of the 1980s,

downwards. If GDP is undercounted by 8 percent or 12 percent, and the entire increment is private consumption of services, household consumption would constitute 42 percent and 44 percent, respectively, of GDP in 2005 (Dragoneconomics Research & Advisory). Even on these alternative assumptions, however, private consumption as a share of GDP would be unusually low by international standards. These adjustments would also lower the investment share of GDP by 3 and 4 percentage points, respectively. The higher consumption and lower investment share of GDP would mean the degree of internal imbalance is less than that reflected in the official data. Note, however, that on these alternative assumptions China's large and growing external imbalance would decline by only a few tenths of a percentage point.

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consumption growth accounted for almost four-fifths of China's economic expansion, whereas in the five-year period 2001–2005 this share fell by half to only two-fifths (National Bureau of Statistics of China 2006b, 70).

Figure 2. China's Household Consumption as Percent of GDP, 1978–2005



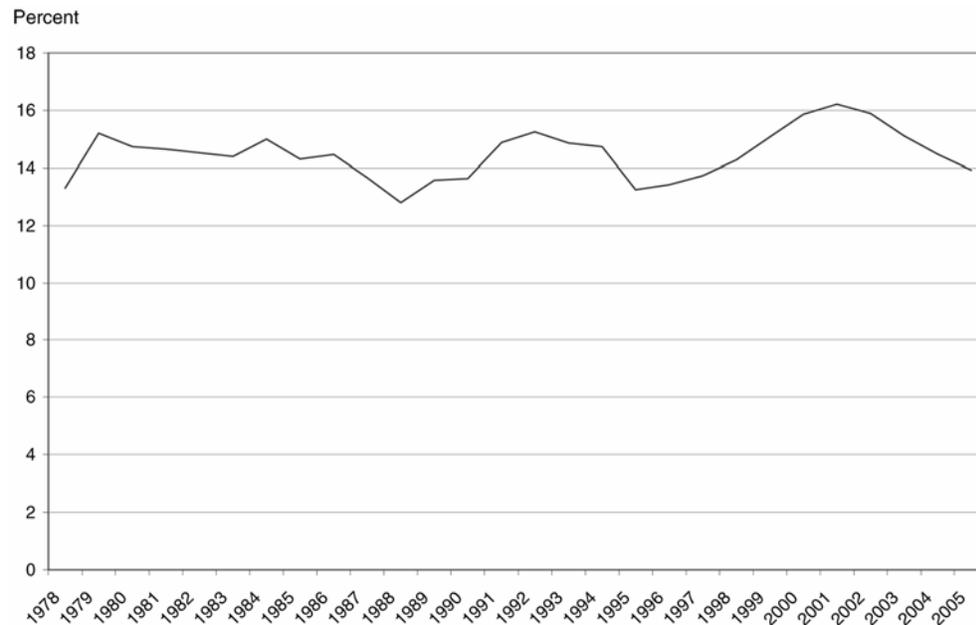
Source: National Bureau of Statistics of China, *China Statistical Yearbook 2006*.

In the last two years, the growth of net exports of goods and services has also become, for the first time in almost a decade, a major source of economic growth. Net exports of goods alone, as reported by China's Ministry of Commerce, tripled from \$32 billion or 1.7 percent of GDP in 2004 to more than \$100 billion or 4.6 percent of GDP in 2005—and then expanded a further 75 percent to reach \$177.5 billion or 6.7 percent of GDP in 2006 (National Bureau of Statistics of China 2006a, 169; Xie Fuzhan).⁶ As shown in figure 4, the net exports of goods and services in 2005 reflected in China's GDP expenditure accounts more than doubled to reach \$124 billion and accounted for one-quarter of the growth of the economy (National Bureau of Statistics of China 2006b, 70). I estimate net exports of goods and services reached \$200 billion in 2006, and that the increase in net exports of goods and services accounted for between a fifth and a quarter of China's growth.⁷

⁶ The ministry's data, which are released monthly, cover goods only and measure imports inclusive of transportation and insurance charges. Thus the ministry's annual import number differs from the data on trade in goods reported in China's balance of payments in which imports, in accordance with standard international conventions, are measured on a free on board (FOB) basis.

⁷ China's Ministry of Commerce reported that the trade surplus was \$177.5 billion. When converted to measure imports on an FOB basis, the goods surplus will be about \$215 billion. Based

Figure 3. Government Consumption as Percent of GDP, 1978–2005



Source: National Bureau of Statistics of China, *China Statistical Yearbook 2006*.

What Prompted the Rethinking of China's Growth Strategy?

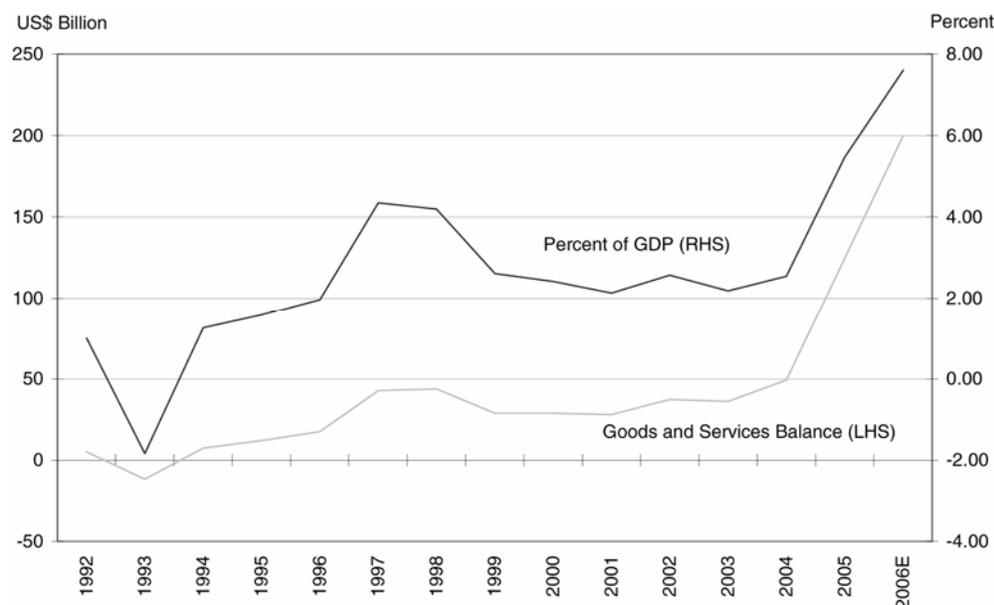
The December 2004 decision of China's leadership at the annual Central Economic Work Conference reflected their judgment that China's growth path was not sustainable in the long run. This does not mean the leadership seeks to slow the rate of economic growth markedly.

Rather, they wish primarily to change the structure of demand and to raise the efficiency of investment. In short, they believe that rapid growth is more likely to prove sustainable if it is generated more by expanding consumption by Chinese households and less by surging investment by Chinese companies and a ballooning global trade and current account surplus.

While the Chinese Communist Party is hardly a transparent decisionmaking body, it appears that several factors underlay its December 2004 policy choice. First, there was growing evidence that investment-driven growth, or what the Chinese sometimes call an extensive pattern of growth, was leading to less efficiency in the use of resources. By most metrics, as investment growth has accelerated, the efficiency of resource use has declined. Multifactor productivity growth, a critical contributor to economic expansion in all economies, averaged almost 4 percent per annum in the first 15 years of economic reform (1978–1993).

on trends in China's services trade, which was a deficit of \$5.6 billion in the first half of 2006, I anticipate a full-year deficit of about \$13 billion, making the goods and services balance about \$200 billion.

Figure 4. Net Exports of Goods and Services, 1992–2006E



Source: National Bureau of Statistics of China, *China Statistical Yearbook 2006*; International Monetary Fund, International Financial Statistics; author's calculations

While still high by international standards, this pace has slowed to only 3 percent since 1993 (Kuijs and Wang 2005, 2). In short, as the investment share of GDP rose, the contribution of productivity improvements to GDP growth fell. In the words of Martin Wolf (2005), the chief economics commentator for the *Financial Times*, the surprising thing about the Chinese economy in recent years is not, as is so frequently asserted, how fast it is growing but rather, given the stupendous share of output devoted to investment, how slowly it is growing.

The slowing pace of factor productivity growth can be attributed in part to overinvestment and the emergence of excess capacity in a number of important industries. China emerged as the world's largest steel producer in 1996 when its output reached 100 million metric tons, putting it ahead of both the United States and Japan for the first time. The industry has continued to grow at a torrid pace. The National Development and Reform Commission (2006) reported that in 2005 output reached 350 million metric tons, and capacity was even larger at 470 million metric tons. Excess capacity of China's steel industry of 120 million tons exceeded the 112.5 million metric tons of steel output in 2005 of the world's second-largest producer, Japan.

As a result of excess production, steel prices by year-end 2005 were down a quarter compared with a year earlier and by one-third compared with the peak levels of March.⁸ This decline in prices has dramatically transformed the industry's profitability. When China's investment rate soared between 2000 and 2004, the demand for steel rose rapidly, and steel industry profits skyrocketed from less than

⁸ Gong Zhengzheng, "Steel Profits Expected to Decline," *China Daily*, January 26, 2006.

RMB5 billion (\$600 million) in 1999 to RMB127 billion (\$15.7 billion) in 2005. But, as excess capacity emerged, the growth of profits waned. Profits of steel firms doubled in 2003 and rose a further 80 percent in 2004 but increased by only 1 percent in 2005. On the back of rising investment demand in the first half of 2006 and the diversion of a part of China's excess supply of steel onto the international market,⁹ prices recovered somewhat in 2006¹⁰ and China's top 82 steel producers were able to eke out an 8 percent profit expansion in the first 11 months of 2006.¹¹ But the steel industry invested about RMB650 billion (\$80 billion) in the five years 2001–2005, of which less than two-fifths (\$30 billion) was financed by after-tax profits. The dramatic slowing in the growth of profits in the industry in 2005–2006 presumably has impaired the ability of some steel firms to service their debt.

The situation is worse in the ferroalloy industry, where capacity utilization in 2005 was only 40 percent. Similar excess capacity has emerged in aluminum, autos, cement, and coke. For example, output of vehicles in 2005 was 6 million units, while capacity was 8.7 million units, with capacity for an additional 2.2 million units under construction. Coke production in 2005 was 230 million tons, but capacity exceeded that by 100 million tons, and the price of coke fell from \$450 per ton in 2004 to only \$130 per ton in 2005.¹² Excess investment also is evident in high-end property in some cities, where prices are now falling for the first time. Even in electric power, which was in acutely short supply only two years ago, excess capacity is expected to emerge by 2007, as additional capacity of 300 gigawatts now under construction or planned comes on stream.¹³

The second reason underlying the leadership decision to rebalance the sources of economic growth is to increase personal consumption and alleviate or at least slow the pace of increasing income inequality. In 2005, personal consumption in China was 30 percent less in real terms than the level that would have been achieved if the household consumption share of GDP had remained at the 1990 level rather than falling by more than 10 percentage points. India offers a useful comparison. In 2004, China's per capita GDP was two and a half times that of India. But, because household consumption as a share of GDP was so much lower in China, per capita consumption in China exceeded that in India by only two-thirds.¹⁴ The ultimate purpose of economic growth everywhere is improvements in human welfare. By this standard, China is falling far below potential.

Similarly, it appears that a significant portion of the increase in income inequality in recent years can be attributed to the highly imbalanced regional

⁹ In 2006, China's steel exports were 43 million metric tons, more than double the level in 2005.

¹⁰ The comprehensive index of steel prices compiled by the China Iron and Steel Association, which fell from 138.3 in March 2005 to 94.18 in December 2005 rose to 114.85 by June 2006 before easing to 105.1 by November 2006.

¹¹ Gong Zhengzheng, "Iron Ore Import Rules Tightened," *China Daily*, December 29, 2006.

¹² Wang Ying, "New Policies Looming for Fragmented Coke Industry," *China Daily*, February 15, 2006.

¹³ Liu Ping, "Overcapacity in 13 Industrial Sectors," *China Economic News*, May 29, 2006, pp. 5–6.

¹⁴ Calculated on the basis of the Indian Ministry of Statistics and Program Implementation, *National Account Statistics*, <http://mospi.nic.in>; IMF, *International Financial Statistics*; and National Bureau of Statistics of China (2006b, pp. 34, 36, 171).

pattern of economic growth. The positive differential in the pace of growth in China's coastal provinces compared to the national average has increased along with the sharply higher pace of growth of foreign trade, particularly exports, that has occurred since 2000.¹⁵ Moving away from heavy reliance on export-led growth thus is consistent with Hu Jintao's emphasis on creating a more "harmonious society," which requires, among other things, more balanced development between coastal and inland areas.

Third, and closely related to the slow growth of consumption, China's extensive pattern of development has generated very modest gains in employment. Between 1978 and 1993 employment expanded by 2.5 percent per annum, but between 1993 and 2004, when the investment share of GDP was much higher than in the 1980s, employment growth slowed to only slightly over 1 percent (Kuijs and Tao 2005). The much more capital-intensive pattern of growth that emerged in the 1990s appears to have contributed to a slower pace of job creation for the simple reason that the steel and other industries producing investment goods employ far fewer workers per unit of capital than do light industries producing consumer goods, not to mention the even less favorable comparison with the service sector.

Another reason China's leadership wishes to transition to a more consumption-driven growth path is burgeoning energy consumption and its detrimental effects on the environment. Investment-driven growth has required the output of machinery and equipment, and the inputs to produce them, to grow much more rapidly than the output of consumer goods. Rapid growth of output of investment goods, in turn, increases the demand for energy disproportionately. China's energy elasticity of GDP growth (the number of units of energy required to produce an additional unit of output) averaged a very modest 0.6 in the 1980s and 1990s, leading over time to a substantial reduction in the amount of energy required to produce each unit of GDP. But this ratio has almost doubled in the past five years (National Bureau of Statistics of China 2006a, 147). Although China continues to achieve energy efficiency gains in the production of virtually all products, from 2001 through 2005 these gains were no longer seen sufficient to offset the effect of the rapid expansion of the most energy-intensive sectors of manufacturing, including coal, steel, chemicals and cement.¹⁶

Since two-thirds of China's energy comes from coal, the burgeoning demand for energy generated by capital-intensive growth boosted coal consumption by two-thirds between 2000 and 2005. Coal consumption reached more than 2 billion tons in 2005, almost twice the level of coal consumption of the United States, even though China's economy is only one-sixth the size of the United States. As a result, China is now the second-largest emitter of greenhouse gas and

¹⁵ From 1978 through 2000, China's trade turnover (imports plus exports) measured in value terms expanded at an average rate of 15 percent per year. From 2000 through 2006, the pace accelerated to 25 percent per year.

¹⁶ For example, in 2003, overall efficiency gains were the equivalent of about 30 percent of the adverse effect on energy efficiency stemming from the structural shift toward the most energy-intensive subsectors of the industrial sector. Jiang Jin, "Managing Energy Demand: The Bridge to Sustainability," *China Economic Quarterly* 10, issue 4, p. 31.

is home to 16 of the 20 cities with the worst air pollution on the globe. As a result of the massive increase in coal consumption, the State Environmental Protection Agency (SEPA) reported that rather than cutting sulfur dioxide emissions in 2000–2005 by 10 percent to 18 million tons as planned, by 2005 emissions rose to 25.5 million tons, 42 percent above the goal.¹⁷

A fifth factor motivating China's leadership to seek a transition to a more consumption-driven growth pattern is less obvious but still important. Excessive reliance on investment and net exports to drive growth in recent years threatens to undo some of the progress China has made over the past six years in developing a commercially oriented banking system. A critical component of this process has been the injection of almost RMB4 trillion (\$500 billion) to cover past loan losses and to raise capital adequacy to meet prudential standards (Ma Guonan 2006). The vast majority of these funds have come directly from the government.

Excess investment in some sectors, leading to excess capacity and falling prices, could create a new wave of nonperforming loans that would erode the substantial balance sheet improvements of state-owned banks over the past few years and could push many city commercial banks, which on average are far weaker, into insolvency. The National Development and Reform Commission (2006) in its report to the National People's Congress acknowledged, "adverse effects of surplus production capacity in some industries have begun to emerge. Prices for the products of these industries dropped and inventories grew, corporate profits shrank and losses mounted, and potential financial risk has increased." The steel industry, just discussed, is but one example.

The absence of significantly rising nonperforming loans in the banking system in the past few years is not necessarily a sign that all is well, since China has had four consecutive years of double-digit growth and corporate profits have been rising, albeit at a more modest rate recently in industries like steel. Moreover, based on China's exploding current account surplus in recent years (see figure 5 and related discussion below) the RMB appears to be increasingly undervalued, contributing to the growth of profits in the tradable goods sector (i.e., manufacturing). Distress in the banking system could emerge, however, either from a slowdown in economic growth over the next few years or from a significant appreciation of the currency. But excess capacity is so large in some industries that their ability to service their debt may be in question, even in an environment of continuing strong economic growth and an increasingly undervalued currency.

A final factor underlining the leadership's desire to transition to a more consumption-oriented growth path is that excess reliance on expansion of net exports (i.e., a growing trade surplus) raises the prospect of a protectionist backlash in the United States and other important markets for Chinese exports. China's central bank, the People's Bank of China, was perhaps the first to explicitly acknowledge this factor in its *Report on the Implementation of Monetary Policy Report 2005Q2*, in which it candidly stated that China's excessive trade surplus "will escalate trade frictions" (People's Bank of China Monetary Policy Analysis Small Group 2005, 28).

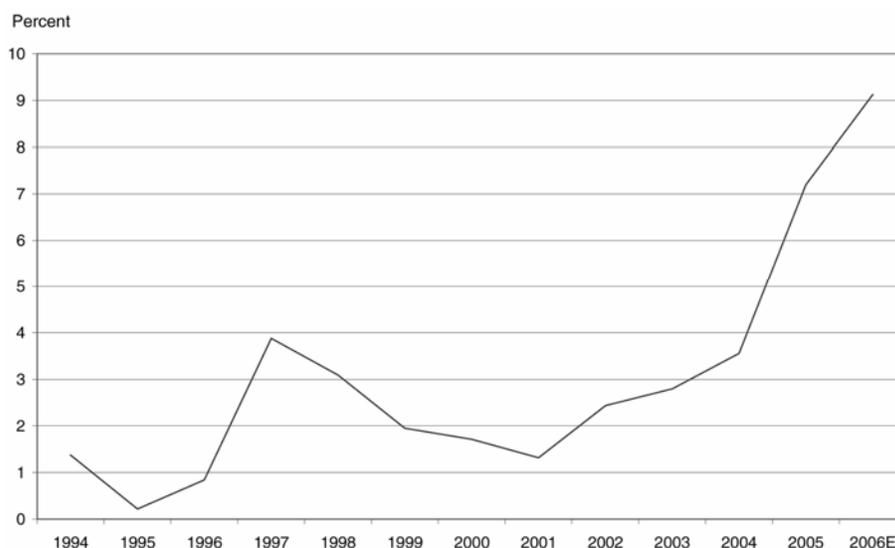
¹⁷ Shai Oster, "Pollutant Takes Rising Toll in China," *Wall Street Journal*, August 4, 2006.

In sum, for a variety of reasons China's top political leadership and its leading economic advisory institutions by late 2004 came to the view that sustaining China's long-term rapid growth trajectory required a significant modification of the underlying growth strategy. Without such a modification, they feared, rapid growth could not be sustained.

What Are the Implications for the Global Economy?

China's new growth strategy, if realized, would have positive implications not only for China, but also for the global economy. As shown in figure 5, China's current account surplus has soared in recent years. In 2006, China decisively surpassed Japan for the first time to become far and away the world's largest global current account surplus country.¹⁸ China now is a major contributor to global economic imbalances, along with the United States, which has the world's largest current account deficit. The successful transition to a pattern of growth driven more by domestic consumption demand necessarily entails a reduction of China's national saving rate relative to its investment rate. That, in turn, would reduce China's current account surplus. This adjustment should be facilitated by an appreciation of the Chinese currency, which would mitigate inflationary pressures that would otherwise emerge from the increase in consumption demand.

Figure 5. Current Account Balance as Percent of GDP, 1994–2006E



Source: National Bureau of Statistics of China, *China Statistical Abstract 2006*; author's calculations.

¹⁸ In 2005, China's current account surplus was \$161 billion, slightly less than Japan's \$170 billion. Japan's surplus in the 12 months through October 2006 was \$168 billion, suggesting a surplus for the calendar year 2006 little changed from 2005. I estimate China's 2006 current account surplus at \$240 billion, based on official data on China's goods trade through November and official data for the first half of 2006 on the other components of the current account—trade in services, investment income, and transfers.

This will happen through two channels. First, appreciation would tend to reduce the pace of export growth and increase the pace of import growth, thus expanding domestic supply. Second, a more flexible exchange rate would allow the government greater flexibility in the use of interest rate policy (Goodfriend and Prasad 2006). As will be argued below, higher real interest rates are almost certainly necessary to reduce China's excessive rate of investment, which in turn is a prerequisite to a successful transition to a more consumption-driven growth path.

How Can China Promote Consumption-Driven Growth?

Promoting domestic demand as a source of economic expansion requires that the growth of household and/or government consumption increase relative to that of the combined growth of investment and net exports. Policies to promote consumption can be based on cutting personal income taxes or increasing government consumption expenditures (i.e., government noninvestment outlays). Shifting to a more consumption-driven growth path in China also will require significant changes in its exchange rate policy. Under current conditions, in which the authorities for several consecutive years have purchased more than \$200 billion per year in foreign exchange, including \$247 billion in 2006, a more flexible exchange rate regime would certainly lead to appreciation of the renminbi, simultaneously tending to reduce net exports and, as will be explained below, increasing the government's flexibility to raise interest rates. The latter is a prerequisite for slowing the rapid pace of investment spending of recent years. Changes in corporate tax policy, discussed below, also offer an important opportunity to rebalance China's sources of economic growth.

In many economies, governments can increase personal consumption through fiscal stimulus in the form of tax cuts on household income. But this avenue is of limited relevance in China, where direct taxes on households are relatively small to start with and the government's cuts have been timid.

The alternative form of fiscal expansion is expenditure based. If tax cuts cannot increase private consumption significantly, the government can increase its budgetary expenditures to add to domestic demand. Given already high levels of investment and the emergence of excess capacity in some industries, however, the government needs to increase its noninvestment outlays, notably those on health, education, welfare, and pensions. There is enormous scope to do so, since governments at all levels combined in China spend only 3 percent of GDP on these programs (National Bureau of Statistics of China 2006b, 288)¹⁹

The government has considerable scope to increase its own consumption expenditures without raising taxes on households, which likely would depress household consumption, offsetting to some degree the increase in government consumption. The government could simply reduce its own investment

¹⁹ Excluding capital expenditures.

expenditures and reallocate the funds to consumption.²⁰ The government itself directly undertakes about 5 percent of all investment, an amount equivalent to a little over 2 percent of GDP (National Bureau of Statistics of China 2006a, 52). In addition, the government budget provides “capital transfers” that are used to finance additional investment expenditures.²¹ For 2003, the most recent year for which China’s National Bureau of Statistics has released the relevant data, these capital transfers were the equivalent of 8 percent of all fixed investment (National Bureau of Statistics of China 2006b, 88-89). Thus the government’s direct and indirect investment outlays combined amount to about 6 percent of GDP. A reduction in the government’s direct investment and cutting capital transfers would free up resources to increase government consumption—that is, outlays for health, education, welfare, and pensions. That would contribute significantly to a rebalancing of the structure of demand, away from investment and toward consumption.

An increase in household consumption as a share of GDP also could play a key role. That, in turn, requires a reduction in the saving rate of households, which has increased significantly since the 1980s and has been running at about 25 percent of disposable income since 2000 (Kuijs 2006). By contrast, in the United States in 2005 households spent more than their disposable income—in other words, Americans’ saving rate was slightly negative!

Any analysis of the likelihood of a reduction in the savings rate of households must begin by analyzing the motives for household savings. One motivation is clearly precautionary—to cope with life’s uncertainties such as illness, unemployment, or injury. As the government and Chinese enterprises have reduced the level of support they provide, these expenditures increasingly have become an individual responsibility. In 2003, for example, in urban areas only about half the population was covered by basic health insurance, and in rural areas less than a fifth of the population was covered by a cooperative health insurance program initiated on a trial basis in 2002 (OECD 2005, 185). As the share of public health expenditures paid directly by the government or borne by enterprises has waned, the share of total health outlays borne by individuals on an out-of-pocket basis increased from around 20 percent in 1978 to a peak of 60 percent in 2001. Between 2001 and 2004 the individual share fell to 54 percent, still more than two and a half times the share of 1978 (IMF 2006, 49; National Bureau of Statistics of China 2005, 770; 2006b, 882). As a consequence, many households save to cover potential future medical expenses. Indeed, the reduction in the share of health expenditures provided through the government and by employers is likely a key reason that household saving as a share of disposable income increased significantly in the 1990s.

In 2005, only 14 percent of China’s workforce was covered by unemployment insurance, and only 11 percent was covered by workers’ compensation (National

²⁰ This reallocation, of course, would reduce government savings since the latter are defined as current revenues less current (i.e., noninvestment) outlays.

²¹ Kuijs (2006, 7) believes these funds are transferred to state-owned enterprises in electric power, water, transport, and other infrastructure sectors.

Bureau of Statistics of China 2006a, 43, 201). Thus the vast majority of workers have to save rather than rely on insurance to compensate for potential income interruption due to job loss or injury, adding further to the incentive for precautionary savings.

Retirement is another significant motivation for households to save. This is particularly true in China because the basic government pension scheme is extremely limited. In 2005, the pension scheme covered 131.2 million workers, only 17 percent of those employed, plus 43.7 million retirees (National Bureau of Statistics of China 2006a, 43, 201). Moreover, a worker now must contribute for a minimum of 15 years before he or she is entitled to draw any benefits at retirement. And the basic pension scheme is designed to provide a pension equal to only 20 percent of average local wages, independent of a worker's lifetime earnings.²²

Over the past decade, Chinese authorities have repeatedly asserted the goal of improving the social safety net, yet pension system coverage is expanding extremely slowly. Between 2000 and 2005, the share of those employed participating in the program rose by only 2.8 percentage points (National Bureau of Statistics of China 2006a, 43, 201; 2005, 117). At that pace, universal pension coverage will not be achieved until 2155—150 years from now.

Surveys in China tend to confirm the importance of uncertainty as a motivation for savings. China's Academy of Social Sciences, for example, found that potential unemployment was the top worry of urban residents, cited by between 39.7 percent and 53.5 percent of respondents in annual surveys from 2001 through 2005. In 2006, concerns about social security, including pensions, health care, and workers compensation displaced potential unemployment as the top concern of urban residents (Zhao Huanxin).

Finally, households also save to finance education expenditures. Families are responsible for a significant share of national expenditures on education, since government expenditures on education amount to only 2 percent of GDP. In 2004, per capita expenditures on education of urban households amounted to RMB560 or 8 percent of total consumption expenditures (National Bureau of Statistics of China 2005, 352). Primary school fees are a large financial burden, particularly for poorer rural households.

In the long run, increased provision of health care, unemployment compensation, and workers' compensation through the government budget can be expected to reduce precautionary saving on the part of households. As families gain confidence that the government will provide more of these services, they will reduce their own saving voluntarily (i.e., increase consumption as a share of their own disposable income). Similarly greater government provision of educational services and old age support could lead to a reduction in savings associated with lifecycle events, such as children's education and retirement.

²² The basic pension scheme, the only one to which enterprises contribute, is the first of a three-pillar retirement program. There are, in addition, mandatory and optional individual contributory pillars. The basic scheme and the mandatory individual schemes combined are designed to replace about 50 percent of pre-retirement income.

In other countries, increased government provision of health services has led directly to an increase in household consumption (China Economic Research and Advisory Program 2005). For example, the introduction of National Health Insurance in Taiwan, which raised the fraction of the insured population from 57 percent in 1994 to 97 percent in 1998, substantially reduced household uncertainty about future health expenditures and thus stimulated increased consumption outlays. Households that previously enjoyed no health insurance coverage increased their consumption expenditures by an average of over 4 percent (Chou, Liu, and Hammitt 2002, 1889).²³ Thus, China's transition to a more consumption-driven growth path will probably need to start with increased government consumption expenditures but with time is likely to be reinforced by changes in household consumption and saving decisions.

For China, exchange rate policy should be an important third element supporting the transition to a more consumption-driven growth path. The reason is that limited flexibility of China's exchange rate is a critical factor constraining the independence of monetary policy. China's central bank has had some success in sterilizing large foreign capital inflows, a key element in its program of controlling the growth of monetary aggregates and bank credit. But it has generally been reluctant to raise domestic interest rates since that would reduce the carry costs of foreigners moving money into China in anticipation of the RMB's appreciation. Since lower carry costs increase the profits to be gained from any RMB appreciation, the authorities fear that raising domestic interest rates could cause capital inflows to become unmanageably large. Fixed nominal domestic interest rates on loans in 2002–2003, when domestic price inflation was rising, led to a sharp decline in and ultimately to negative real interest rates on loans. Between the first half of 2002 through the third quarter of 2004, the real interest rate on loans fell by 13 percentage points, from almost 9 to –4 percent.²⁴ That fueled a very large increase in the demand for bank loans and thus a sharp increase in capital formation.

A more flexible exchange rate policy would allow the central bank greater flexibility in setting domestic interest rates and thus increase the potential to mitigate macroeconomic cycles by raising lending rates to moderate investment booms. That would lead, on average, to a lower rate of investment. A reduction in the rate of investment is a critical component of the policies to transition to a more consumption-driven growth path. In the absence of a reduction in investment, increased consumption demand would lead to inflation.

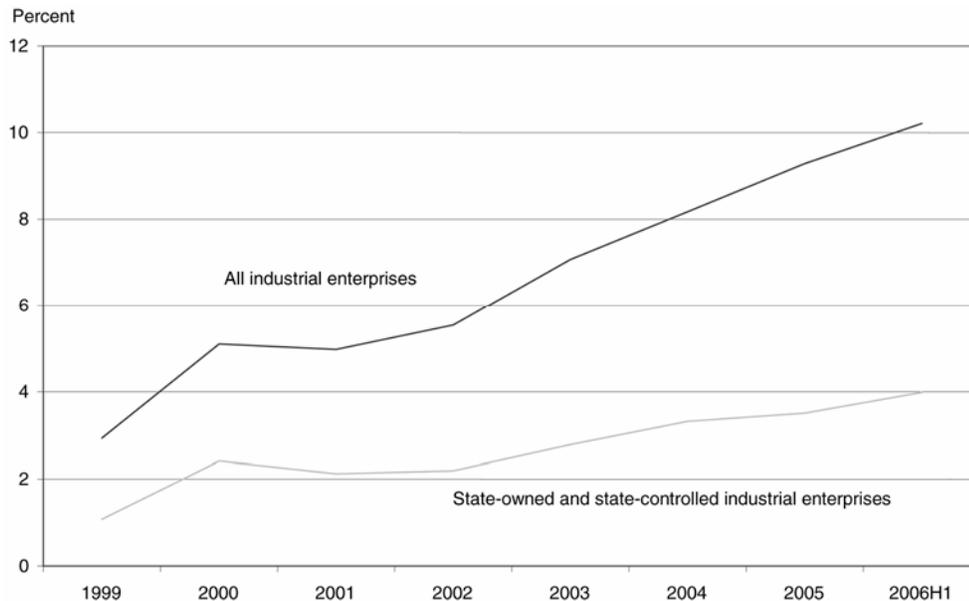
Finally, corporate tax policy should contribute importantly to the rebalancing of China's sources of economic growth. As shown in figure 6, from 1998 through the first half of 2006, profits of industrial enterprises in China soared from 2 percent to over 10 percent of GDP (National Bureau of Statistics of China 2005, 494; People's Bank of China Monetary Policy Analysis Small Group 2006a, 33).

²³ Consumption increased by 2.6 percent in households where one spouse was not in the labor force or unemployed and by 5.7 percent in households where both spouses worked.

²⁴ The real interest rate is calculated as the one-year lending rate minus the inflation rate reflected in the corporate goods price index. The latter index is compiled and published by the People's Bank of China.

Although these profits are subject to China's corporate income tax, estimated retained after-tax earnings of industrial firms in the first half of 2006 amounted to 7.6 percent of GDP, compared with an estimated 1.5 percent in 1998.²⁵ In addition, industrial firms retain depreciation funds that amount to another 6 to 7 percent of GDP (Kuijs, Mako, and Zhang 2005).

Figure 6. Industry Profits as Percent of GDP, 1999–2006H1



Source: National Bureau of Statistics of China, *China Statistical Yearbook 2006*; People's Bank of China Monetary Policy Analysis Small Group, *Report on the Implementation of Monetary Policy 2006Q2*.

Unfortunately, in state-owned firms these funds are not subject to a significant rate of return test prior to being reinvested. The reason is that the only available alternative to reinvestment is low-yielding bank deposits. Taking into account the relevant measure of inflation, the real after-tax rate of return on corporate deposits is typically negative.²⁶ Given a negative real rate of return on deposits,

²⁵ Before tax profits of industrial firms with sales above RMB5 million were RMB810 billion in the first half of 2006 (People's Bank of China Monetary Policy Analysis Small Group 2006a, 33). In 2004, the profits of all industrial firms exceeded those of firms with sales of more than RMB5 million by 15 percent. Assuming this ratio was unchanged in the first half of 2006, profits of all industrial firms in the first half of 2006 can be estimated at RMB933 billion. China's three largest oil producers are subject to a windfall profits tax, which amounted to RMB16.19 billion in the first half of 2006. Profits also are subject to the corporate income tax. While the statutory rate is 33 percent, various tax waivers reduce the applied rate to 24 percent for most domestic enterprises (Zhu Zhe). Assuming the average corporate tax rate on domestic firms is 24 percent, after-tax profits can be estimated at RMB700 billion or 7.6 percent of reported first half GDP of RMB9,144 billion.

²⁶ For example, starting August 15, 2006, the People's Bank of China raised the nominal interest rate on a one-year term corporate deposit to 2.52 percent. The corporate goods price index in

from the point of view of an enterprise manager it is rational to reinvest retained profits and depreciation funds—even when they have slightly negative anticipated rates of return.

Given the strong upward trend in profits as a share of GDP since 1998 and apparent upward trend in depreciation funds as a share of GDP as well, retained earnings have become an increasingly important source of investment financing in China's corporate sector and have contributed to the rising investment share of GDP in recent years.

For a number of years, the authorities have discussed requiring state-owned enterprises to pay dividends to their owner—the government (Kuijs, Mako, and Zhang 2005). This policy has the potential simultaneously to reduce the pace at which investment grows, or at least subject investment to a more demanding rate of return hurdle, and to provide the government with additional resources that could be used to enhance government-provided social services.

How Aggressively Has China Pursued a Consumption-Driven Growth Path So Far?

Even before the 2004 Central Economic Work Conference, which formally endorsed the transition to a more domestic consumption-driven growth path, the government initiated a program to raise farm incomes by reducing the agricultural tax, long levied on farm income (Ministry of Finance, Ministry of Agriculture, and State Tax Bureau). In 2004, the tax, which was set at 8.4 percent of average yields, was eliminated in two provinces and reduced by 3 percentage points in 11 provinces and by 1 percentage point in all other provinces.²⁷ By the end of 2005, the government had eliminated the tax in 28 provincial-level administrative units and had reduced it to less than 2 percent in the remaining three provinces, where the tax was eliminated entirely in 2006 (State Tax Bureau 2005b).

The early initiative to eliminate the agricultural tax was followed in 2006 with a doubling to RMB1,600 of the monthly income exempt from the personal income tax levied on wage earners, who live almost exclusively in urban areas.

The central government also has encouraged local governments to raise the minimum wage in urban areas, potentially increasing the consumption of low-income workers.

All of these initiatives, however, are modest. Agricultural taxes collected fell from RMB33.7 billion in 2003 to RMB19.79 billion in 2004 and then to only RMB1.279 billion in 2005 (National Bureau of Statistics of China 2005, 281;

August 2006 was up 2.9 percent compared with August 2005, making the real return -0.38 percent. Nominal returns on short-term deposits are less than 2.52 percent, as low as 0.72 percent for demand deposits, making the real return on deposits of less than one year as low as -2.18 percent.

²⁷ In 2004, the tax was eliminated in Jilin and Heilongjiang provinces, cut by 3 percentage points in 11 other grain-growing provinces (Hebei, Inner Mongolia, Liaoning, Jiangsu, Anhui, Jiangxi, Shandong, Henan, Hubei, Hunan, and Sichuan), and reduced by 1 percentage point in all other provinces.

2006a, 75). The tax burden on farmers was reduced by RMB23.4 billion in 2004 and an additional RMB22 billion in 2005 (Ministry of Finance 2005; State Tax Bureau 2005b). However, RMB23.4 billion is the equivalent of only 1 percent of rural consumption expenditure or 0.1 percent of GDP in 2004. Moreover, the cut in the agricultural tax was at least partially offset by increases in other taxes levied at least in part on rural residents. In 2004, proceeds from the tax on occupied, cultivated land and the tax levied on contracts used to transfer land use rights or the sale, exchange, and inheritance of houses increased by one-half or RMB21 billion. The same taxes rose by an additional one-third or RMB22 billion in 2005. While not all of these increased taxes were born by farmers, these increases likely at least partially offset the reductions in the agricultural tax (National Bureau of Statistics of China 2005, 281; 2006a, 75).

Similarly, reductions in the personal income tax are not a very potent policy instrument to stimulate consumption. The proceeds of the personal income tax in 2005, prior to the tax cut, amounted to RMB210 billion, only 1.1 percent of GDP (National Bureau of Statistics of China 2006a, 20, 66). By comparison, the personal income tax in the United States prior to the major income tax cut under President George W. Bush in 2001 represented almost 10 percent of GDP. Tax cuts in the United States reduced this share to about 7 percent, translating into an increase in household disposable income of over 4 percent. In contrast, China starts with an income tax one-tenth the relative size of that in the United States, and doubling the income tax exemption is a modest tax cut. The State Tax Bureau (2005a) reported that raising the exemption would reduce the personal income tax take by RMB28 billion in 2006. But this was only 0.13 percent of GDP,²⁸ a tiny amount compared with the Bush tax cuts, which reduced personal income taxes by 3 percentage points of GDP.

Finally, it is unlikely that the increase in minimum wages that went into effect on July 1, 2006, in most administrative jurisdictions had a significant positive effect on household consumption expenditures. There are two reasons for this. First, the Regulations on the Minimum Wage of the Chinese Ministry of Labor and Social Security (2003) give local governments considerable leeway in setting the minimum wage. In practice, in most jurisdictions, the minimum wage is only about one-fifth to one-quarter the average wage prevailing locally.²⁹ Second, the share of the workforce earning the minimum wage appears to be quite small. In Beijing, for example, minimum wage workers accounted for only 2.4 percent of the workforce in 2002.³⁰ Given the low ratio of the minimum wage to the average wage and the small share of the workforce earning the minimum wage, the 6.5

²⁸ Based on the preliminary 2006 GDP figure of RMB20,941 billion reported in January 2007 (Xie Fuzhan).

²⁹ In Beijing, in 2002 and 2003, the minimum wage was 25.5 and 23.5 percent, respectively, of the average wage in those years. In 2004, in Shenzhen, the minimum wage was 18 percent of the average local wage (China's highest).

³⁰ China Statistical Information Net, "Wages of Beijing Workers and Staff Increase Steadily; Differentials across Industrial Branches Expand," www.hebei.gov.cn/economy/stat/column_detail.jsp?id=8515&subjectname=%E7%BB%9f (accessed July 10, 2006).

percent rise in the capital's minimum wage in 2003 could not have had more than a miniscule effect on the total wage bill.³¹

More generally, the past decade's data suggest that China's minimum wage program has had a modest effect on household consumption. During this period, the minimum wage in Beijing more than doubled, from RMB270 per month in 1996 to RMB640 in 2006. In the Shenzhen special economic zone the minimum wage doubled from RMB398 to RMB810 over the same period.³² Presumably, minimum wages in other jurisdictions have had similar rates of increase. But, as already noted, over this period household consumption as a share of GDP fell significantly.³³

It is unlikely that the further 10 percent increase in Beijing's minimum wage in July 2006, to RMB640 per month, and the similar increases in other cities significantly increased wage income. Thus, even allowing for minimum wage workers' likely higher marginal propensity to consume, the expected effect of China's minimum wage program on household consumption expenditures is likely to be small.

In summary, the cuts in taxes on rural and urban incomes instituted by the central government beginning in 2004 and the increases in minimum wage levels introduced by provincial and local governments have had and are likely to continue to have only a modest positive effect on household disposable income. Thus, they are unlikely to lead to significantly higher levels of household consumption expenditures. The cuts in taxes on urban and rural incomes are too small, and in rural areas they have been at least partially offset by increases in other taxes that fall partially on farmers.

On the other hand, the government expenditures on health, education, and other social programs have increased quite significantly in the past two years. The centerpiece of this effort is Premier Wen Jiabao's program to create a "new socialist countryside." The program entails increased subsidies for grain producers, designed to raise the incomes of some of China's poorest farmers; expanding the coverage of the rural cooperative medical system, which was first rolled out on a trial basis in 2002; and eliminating educational fees for rural primary education.

The increase in expenditures on some of these programs is impressive.³⁴ Outlays by the central government on the rural cooperative medical system rose seven fold to RMB4.27 billion in 2006, allowing the number of rural residents

³¹ In 2002, the share of Beijing's wage income earned by minimum wage workers can be estimated as 0.6 percent of total wage income (0.25×0.024). Assuming generously that the 6.5 percent increase in the minimum wage in 2003 had no effect on the number of minimum wage workers employed, the increase in the minimum wage would have raised total wage income by 0.04 percent.

³² See "Historical Minimum Wage Standards," <http://www.labourlawyer.com>.

³³ China's minimum wage system was established in 1993.

³⁴ Data in the paragraphs that follow is taken from speeches presented at the National People's Congress in Beijing in early March. I have relied on the unofficial English-language texts distributed at the Great Hall of the People. As this is written, the final, official texts of these speeches have not yet been released by the Xinhua News Agency.

covered by the program to more than double to 410 million. The government has pledged to make the program available in 80 percent of all administrative units by the end of 2007, an increase of almost seven fold compared to 2004. The government budgeted RMB220 billion (\$27.5 billion) over five years (2006–2010) to provide free rural primary school education, a significant commitment. Expenditures on this initiative in 2006 were RMB36.6 billion, allowing the government to eliminate tuition and miscellaneous school fees for 52 million students in 12 western provinces. The program will reach a total of 150 million students in 2007 when central and eastern provinces will be brought into the program.

More broadly, government budgetary outlays on health programs expanded by an average of one-quarter in both 2005 and 2006, a substantial acceleration compared with an annual expansion of only 15 percent in the previous four years. This year the government is launching a pilot program to provide basic medical insurance for urban residents who are unemployed or do not receive medical insurance through their employers.

Increased government expenditures on these programs raises the consumption share of GDP above the level it would otherwise attain, thus helping to rebalance the sources of economic growth. Moreover, if the rapid pace of government spending on these programs is sustained over a period of years, eventually households are likely to reduce their precautionary saving and increase consumption. That adjustment would further enhance the consumption share of GDP and, equally important, contribute to a moderation of China's large external imbalance as well.

In July 2005, the Chinese authorities launched an exchange-rate reform with several components: an initial revaluation by 2.1 percent vis-à-vis the U.S. dollar; announcing that the currency could fluctuate by up to 0.3 percent per day and that its value increasingly would be determined by supply and demand in the market; and asserting that the renminbi would be managed with reference to a basket of currencies, rather than simply being pegged to the U.S. dollar. These reforms could have led to a more flexible exchange rate and thus given the People's Bank of China greater flexibility in adjusting interest rates.

But to date these reforms have not resulted in much flexibility. The potential for the currency's value to move by as much as 0.3 percent per day has been largely theoretical, and massive government intervention in the foreign exchange market continues to prevent the currency from appreciating significantly. Between August and December 2005, the authorities purchased an average of \$19 billion per month, almost exactly the pace of intervention that occurred in the first six months of the year. In 2006 the average market intervention increased slightly to an average of \$20.6 billion for a cumulative total of \$247 billion. This directly contradicts the People's Bank of China announcement of the new exchange-rate system in 2005, which emphasized market forces and specifically stated that supply and demand would play an increasing role in determining the exchange rate. As a result of continued massive government intervention in the market, the cumulative appreciation of the renminbi vis-à-vis the dollar since the introduction of the "new" exchange rate system is only 6.5 percent. Less noticed, on a real

trade-weighted basis the RMB appreciated only slightly between mid-2005 and the end of 2006, contributing significantly to China's now record setting current account surplus.³⁵ Equally important, the continued massive undervaluation of the currency limits the ability of the authorities to use monetary policy to manage the economy.

It is not clear that corporate tax policy is evolving in a way that will facilitate a rebalancing of the source of economic growth. In September 2006, Li Rongrong, chairman of China's State-Owned Asset Supervision and Administration Commission (SASAC), announced that the government would begin collecting such dividends in 2007.³⁶ But until the details of this program are clear, it is premature to judge its effects. First, the magnitude of required dividend payments has not been announced. If all state-owned and state-controlled industrial companies were to pay half their after-tax income as dividends, this would have amounted to 1.5 percent of GDP in the first half of 2006.³⁷ Additional dividends could also be collected from state-owned firms in the construction and services sectors. However, Mr. Li indicated that the dividend tax would be imposed only on those state industrial enterprises directly administered by SASAC in Beijing, suggesting that nonindustrial state companies, as well as those state industrial firms under the jurisdiction of provincial SASAC bureaus, would be exempt. Thus the magnitude of dividend payments could be more modest than suggested above.

More important, Mr. Li has always insisted that the dividend payments would not be made to the Ministry of Finance, where they would be subject to budgetary allocation and thus would potentially be a source of funding for additional government-provided social services. Rather, he has asserted that dividend payments would be made directly to SASAC, which in turn would use the funds to finance investment outlays. If this approach were to be adopted, a dividend policy would not reduce the corporate savings rate and would not contribute to a rebalancing of the sources of economic growth.

One additional important development—a decline in borrowing by consumers since 2003—suggests that the transition to a more consumption-driven growth path will be difficult, at least in the short run. Consumers' inability to borrow against future income historically has been an important factor contributing to a high rate of household saving in China. This began to change in the late 1990s, when banks first started lending to consumers. Net annual lending to households grew rapidly from only RMB30 billion in 1998 to RMB510 billion in 2003. By the end of 2003, loans to households accounted for 10 percent of all

³⁵ JP Morgan's index (2000 = 100) of China's real trade weighted exchange rate moved from 97.7 in June 2005 to 99.2 in December 2006, an appreciation of 1.5 percent.

³⁶ Rick Carew, "China Expects to Collect Dividends by Next Year," *Wall Street Journal*, September 18, 2006.

³⁷ Profits of all industrial firms sector in the first half are estimated to be RMB933 billion (see note 25). I assume that 41 percent accrued to state-owned and state-controlled firms, the share they accounted for in 2005 (National Bureau of Statistics of China 2005, 491 & 497; 2006b, 509). Deducting the windfall profits tax of state-owned oil companies and the average corporate income tax of 24 percent (see note 25) results in an estimate of after-tax profits of RMB280 billion or 3.0 percent of GDP.

bank loans outstanding. Subsequently, however, lending to households fell to RMB435 billion in 2004 and then to RMB200 billion and RMB210 billion in 2005 and 2006, respectively. Thus new lending to households in each of the past two years was less than half the amount in 2003 and actually well below the level RMB290 billion in 2000, when the Chinese economy in nominal terms was less than half that of 2006.³⁸ The slowdown in borrowing appears to reflect some combination of declining consumer confidence, borrower sensitivity to higher interest rates on home mortgages, escalating housing prices that limit housing affordability for many Chinese, and a decline in the willingness of banks to finance auto purchases, given difficulties that emerged in auto lending a few years ago. The implications for consumption growth are adverse, since home purchases typically lead to increased expenditures on furnishings, appliances, and so forth, all of which are included in household consumption expenditure.

Glass Half Full or Half Empty?

The evidence to date suggests that the transition to more consumption-driven growth is off to a slow start. In 2006, the pace of investment demand may have moderated slightly, but China remained heavily dependent on a growing trade surplus to sustain its high growth rate.³⁹ China's trade surplus for the full year expanded by fully three-quarters, and I estimate the surplus in goods and services rose by \$75 billion or 60 percent, meaning that net exports as a share of GDP continued to rise rapidly.⁴⁰ Since GDP is the sum of capital investment, consumption (household and government), and net exports, the relatively rapid rise of net exports and a moderation of capital investment suggests that the share of consumption in GDP changed only slightly. But the PBOC *2006Q3 Monetary Policy Report* estimated that, for the first three quarters of 2006, final consumption accounted for only 35.7 percent of economic growth, far less than the final consumption share of GDP of 51.9 percent in 2005 (People's Bank of China Monetary Analysis Small Group 2006b, 28). Since a component's contribution to growth can be less than its initial share only if it is growing more slowly than

³⁸ These data are for what Chinese sources call "household consumption loans," which include loans for mortgages, car purchases, tuition, and general consumer credit. They do not include what are called "household economic loans," which are working capital loans extended to Chinese peasants for the purchase of seeds, fuel, fertilizer, and other agricultural inputs.

³⁹ Chinese data on "fixed asset investment," which are published monthly, include the value of land sales, as well as the value of mergers and acquisitions (M&A) transactions. Since these transactions reflect changes of ownership rather than additions to productive capacity, they should not be included in fixed investment. Data on capital formation, which do not include the value of land transactions or M&A activity, are only published annually in China's GDP expenditure accounts. These data are released in May, so are not available as this is written. In 2006, fixed asset investment grew by 24 percent or about 2 percentage points less than in 2005, while GDP growth was a half a percentage point higher. That suggests that capital investment as a share of GDP in 2006 may have eased off a bit more than in 2005 when it fell by 0.6 percentage points.

⁴⁰ I estimate that net exports of goods and services as a share of GDP rose by 2 percentage points, from 5.6 percent to 7.6 percent. China's full-year balance of payments data are not available as this is written.

underlying GDP, the PBOC analysis suggests the growth of consumption demand was relatively slow in the first three quarters of last year. A more accurate picture of trends in consumption will be available when the GDP expenditure data for 2006 are released. For the present, the tentative conclusion is that China is not yet on a path of more domestic consumption-driven growth.

Similarly, Premier Wen Jiabao acknowledged that while energy consumption per unit of GDP fell by 1.2 percentage points, this was far below the Eleventh Five-Year Plan goal of reducing the consumption of energy per unit of output by 4 percent annually each year through 2010.

The reasons government policy has thus far failed to put China clearly onto a new growth path are several. First, the tax burden on rural residents has eased only slightly. Second, income tax cuts for urban wage earners are too modest for cuts to have a major effect on disposable income and thus potentially on consumption. And while the level of some social services financed through the budget has increased, this does not yet appear to have led to a reduction in the precautionary demand for savings on the part of China's households.

Similarly, there is only limited evidence of a more flexible exchange rate and increased independence of monetary policy that would allow higher domestic interest rates, which would reduce the implicit subsidy to investment. Government agencies issue repeated directives calling for reduced investment in sectors with excess capacity. But even after two modest increases in interest rates on loans in 2006, the rates paid by corporate borrowers remain very low in real terms.⁴¹ In the first half of 2006, the increase in bank credit outstanding, almost entirely to corporate customers, was 50 percent greater than in the first half of 2005 (People's Bank of China 2006b). Equally important, the real interest rate on corporate bank deposits remains negative, almost insuring that state-owned companies reinvest all of their retained earnings, even when expected returns are low or even moderately negative. While much discussion has occurred, the government has not yet implemented a corporate dividend tax. Moreover, even if implemented later in 2007 it is not yet clear that it will be structured in a way that will contribute to a rebalancing of the sources of economic growth. Finally, consumer confidence seems to be waning, with a marked slowdown in borrowing from 2004 through 2006.

All of these factors suggest that China's transition toward more consumption-driven growth will require more vigorous government policy action than we have seen to date, especially on the exchange rate and the corporate dividend tax.

⁴¹ Effective August 15, 2006, the benchmark rate on a one-year loan was raised 27 basis points to 6.12 percent. The corporate goods price index in December 2006 rose 3.1 percent over a year ago, making the real lending rate faced by corporate borrowers only 3 percent, an extremely low rate in an economy growing at more than 10 percent.

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