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**The New Stage of Chinese Economic Transformation and “Going-out”**

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## Theme

- Prior to the Great Recession, Chinese economic transformation exhibited a tendency of converging to what can be called the “Golden Age model” – characterized by parallel growths in consumption and investment, and in productivity and the wage rate.
- This tendency has been, since 2008 until now, fundamentally undermined by a process of financialization – so much so that the economy has been impaired with serious volatility and stagnation, and the prospects for the future has become uncertain.
- Broadening the vision, it can be judged that financialization is not just a product of policy orientation and, behind it, political-economic special interests; there are also intrinsic problems with the underlying path of economic development (excess capacity, trade friction, diminishing scope for technology imports, accumulation of official reserves...).
- “Going-out” is thus necessary for overcoming the problems, but this would inevitably involve the internationalization of the Yuan – and hence the need for financial expansion. Crucial is whether financial expansion is to serve, or to crowd-out, productive investment.

- Initiatives and strategies associated with Going-out – “One-belt, One-road”, the AIIB, the New Development Bank, etc. – could be understood as attempts that are in line with the orientation of subsuming financial expansion under productive investment.
- If the orientation is successfully realized, there is a good chance that Chinese economic transformation and the Going-out initiatives will serve as a countervailing force to financialization worldwide.
- Against this background, the rest of the developing world – Latin American economies in particular – could expect to continue to see commodity booms in the future, particularly in connection with the China-initiated infrastructural construction worldwide.
- Whether or not this will help to promote true development – including re-industrialization – in Latin American economies depends on (a) the terms of trade between them and China, and (b) the capability of their domestic political economy in overcoming Dutch-Disease-type hindrances to social and economic development. Thus far, the situation has seemed to be positive regarding (a), but quite unclear regarding (b).

## China Converging to the “Golden Age Model”?

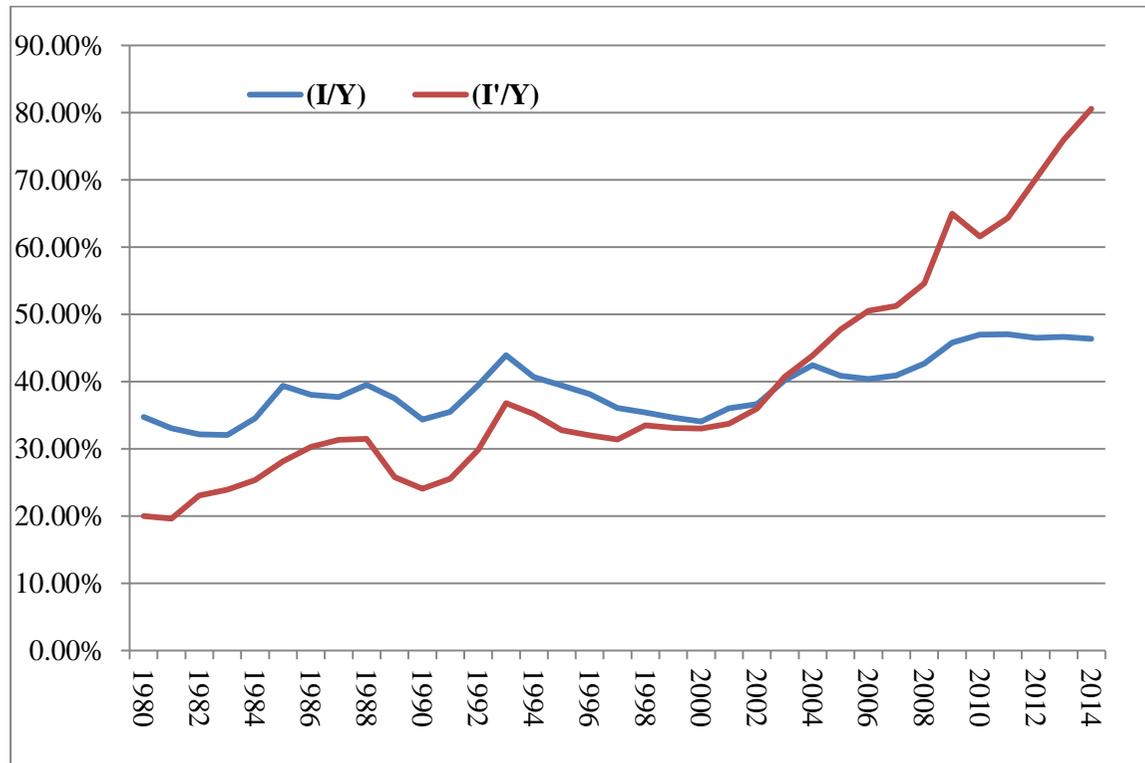
Chinese economic growth since the late 1990s until the present time has followed an investment-led, or capital-deepening, path. This is most clearly indicated by the persistent rise in the investment-to-GDP ratio ([Figure 1](#)).

Contrary to common perceptions, this investment-led growth path has been accompanied by a trend of fast, and accelerating, growth of consumption ([Table 1](#)).

Consumption growth has been underpinned by fast growth in output, and, ultimately, fast growth in productivity – all at unprecedentedly fast paces since the late 1990s ([Table 2](#)).

In this connection, rapid growth in the wage rate has also been clearly evident since the turn of the century – not only for employees in the formal establishments ([Figure 2](#)) but rather in the secondary and tertiary sectors of the economy as a whole.

Figure 1. Investment-GDP ratio (%)



Sources: *China Statistical Abstract* 2015.

Note: I = gross capital formation; I' = total fixed-asset investment; Y = GDP.

**Table 1. Consumption and Investment: Average Annual Real Growth Rates (%)**

	<b>Consumption</b>	<b>Investment</b>
1978-2014	<b>9.25</b>	11.08
1978-1992	<b>8.28</b>	9.32
1993-2014	<b>9.87</b>	12.21
1993-2002	9.63	10.11
2003-2014	10.07	13.99
2003-2007	10.07	16.43
2008-2014	<b>10.07</b>	12.28

Sources: *China Statistical Abstract* 2015.

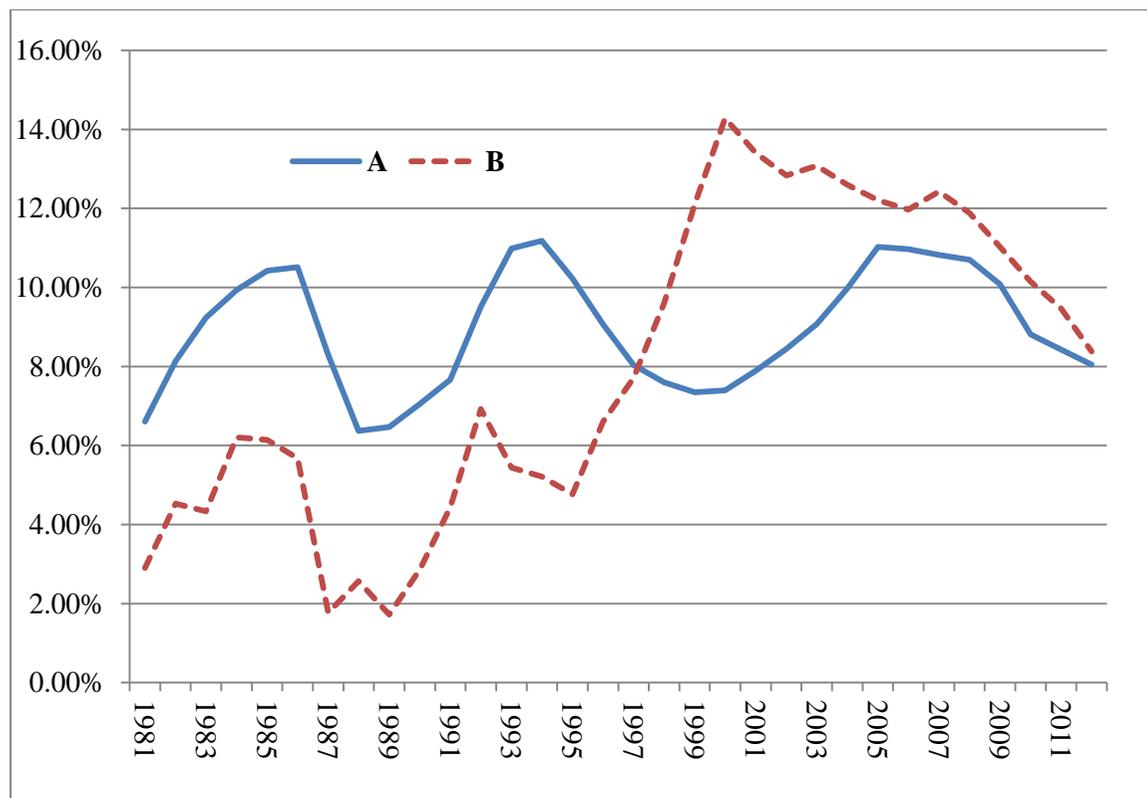
Note: Consumption and Investment (i.e., gross capital formation) are both components of aggregate expenditures. Their real growth rates are calculated by using the consumer price index and fixed-asset investment price index, respectively, as the price deflators.

**Table 2. Real GDP and Total Labour Employment: Average Annual Growth Rates (%)**

	(a) <b>Real GDP</b>	(b) <b>Total Employment</b>	(a)-(b)
1978-2014	9.73	1.44	<b>8.29</b>
1978-1992	9.43	2.67	<b>6.76</b>
1993-2014	9.92	0.71	<b>9.21</b>
1993-2002	9.83	1.03	<b>8.80</b>
2003-2014	9.99	0.44	<b>9.55</b>
2003-2007	11.65	0.55	<b>11.10</b>
2008-2014	8.82	0.36	<b>8.45</b>

Sources: *China Statistical Abstract* 2015.

**Figure 2. Real growth of per-capita GDP and urban wage rates (5-year moving average)**



Sources: *China Statistical Yearbook* and *China Statistical Abstract*, various years.

Notes: A = per capita real GDP; B = urban real wage rate. Note that the wage data cover the formal establishments only.

Simultaneous growths in productivity and the wage rate, and in consumption and investment, are precisely the defining characteristics of the development model in advanced economies in the Golden Age of 1950-1973. Central to the model is the existence of structural-institutional conditions that underpin persistent growth in productive investment.

The structural dynamics of the model: (a) in production, it requires parallel growths in the capital-labour ratio and labour productivity; and (b) in distribution, it requires parallel growths in labour productivity and the wage rate. These results in stable shares of labour and capital in total output, and hence parallel growths in consumption and output. The end result is a stable profit rate, which underpins the growth in productive investment.

In the institutional dimension, both for enhancing work intensity and gaining economies of scale, there requires the existence of “Big Business” . But “Big Labour”, i.e., collective bargaining, would then be needed as a countervailing force – in order to ensure wage growth catching up with productivity growth (and hence consumption growth catching up with output growth).

Insofar as wage growth lags behind, “Big Government”, i.e., the welfare state, will need to come out as the remedy. Government promotion of productive investment, and restriction on alternative allocation outlets (esp. financialization), is also needed insofar as productivity growth is insufficient to induce productive investment.

“State capitalism/socialism, Chinese style”: (a) the system of public finance has been geared towards promoting infrastructure investment; (b) the research and development of frontier and strategic technology have been mainly driven by state promotion or inducement; (c) state banks have been instrumental to productive investment; and (d) state-owned enterprises (SOEs) have continued to be the main carriers of the structural dynamics of Chinese economic transformation.

State orientation towards constructing a welfare state has also been evident. A publicly-funded healthcare system was (re)established to cover almost the entire population. Provision of affordable housing for the urban low-income people has also been on the government agenda. Most far-reaching, there has emerged a new policy line that emphasizes labour compensation-enhancing economic growth, rather than growth based on “cheap labour” (hence, unionization, collective bargaining, employment contract law, minimum wage legislation, etc.).

## The Financialization Turn

Since 2008, financialization and the expansion of speculation have largely weakened the dynamism of the Chinese economy in its convergence towards the Golden Age Model. What have prevailed are asset bubbles, systematic risks, and austerity in policy orientations.

The ballooning property bubble can be gauged by looking at the trend of expansion of total fixed-asset investment (*FAI*), which broadly encompasses property investment (*PI*) and gross capital formation (*GCF*). As was indicated earlier in **Figure 1**, *FAI* has persistently exceeded *GCF* since 2004, by a substantial margin. In 2014, *FAI* exceeded *GCF* by a gigantic magnitude of 34% of GDP.

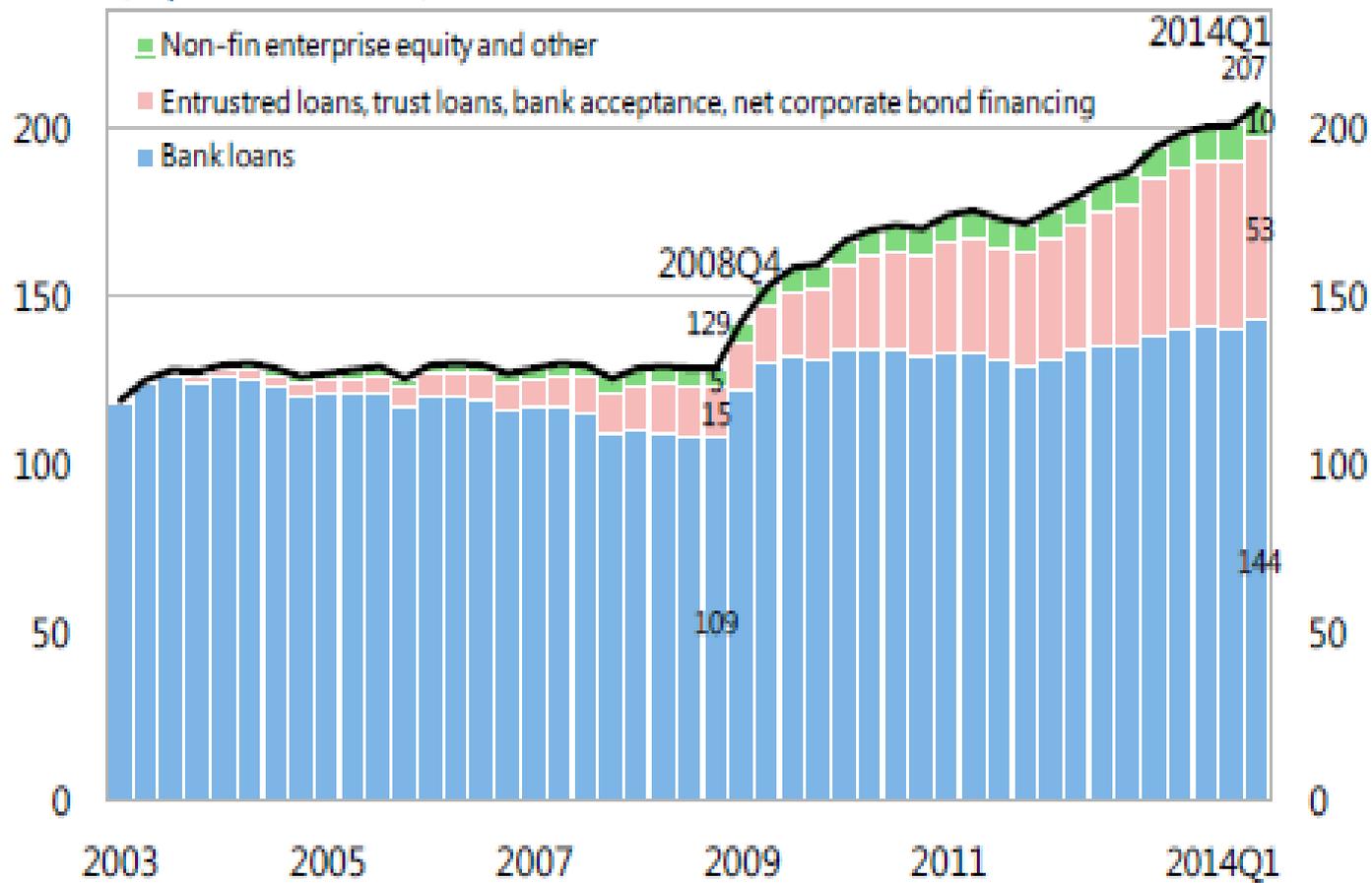
The fact that the *GCF/GDP* ratio remained basically unchanged in the years 2009-2014 suggests that bubble-type property investment might have crowded out productive investment, and this might have in part accounted for the slowdown in economic growth in recent years.

This judgement is supported by the evolution of the composition of the stock of “aggregate financing to the real economy” (AFRF) (Figure 3). In the years 2003-2008, the ratio of AFRE to GDP remained basically unchanged. Thereafter, it surged from 129% in late 2008 to reach 207% by early 2014. The increases were mainly accounted for by non-bank financing activities, which were far less regulated than banking activities (and the banks themselves were heavily involved in under-regulated activities).

Against this background, the boom and bust in the Chinese stock market in 2015 can be seen as reflecting attempts hopefully to scale down the debt-to-GDP ratio – only to result in severe volatility, and likely further damages to the growth potential of the economy.

The persistent financial expansion, and the flows of capital to the bubble sectors, might well be the result of policy orientations. It can be argued that this is a case of the “Greenspan Put”. As the banks and the economy as a whole have been held hostage by speculative capitals, the government has had to be exceedingly cautious in order not to let the bubbles go burst. The result is continuous crowding out of productive investment.

**Figure 3. Stocks of Aggregate Financing to the Real Economy (Ratios of GDP) (%)**



Sources: IMF (2014) “People’s Republic of China: 2014 Article IV Consultation”, IMF Country Report no.14/235.

## The Broader Conditions and Going-out

But, financialization – which takes the form of speculation crowding-out investment – could also be product of the broader conditions, both domestic and external.

It has been induced by profitability decline in the productive sector. There exists a widely-held claim that this decline is intrinsic of the capital-deepening path of economic growth, typically via its tendency to cause excess capacity. This claim has its theoretical foundation both in neoclassical economics (diminishing marginal productivity of capital) and Marxian economics (tendency of the profit rate to fall). In both cases, however, there remains the possibility that the tendency of profitability decline can be off-set by technological progress.

Insofar as this claim has its elements of empirical truth, and noting that capital-deepening growth has prevailed in China for more than two decades, it is critical that China has indeed faced increasing difficulties to generate rapid technological progress – it has been approaching the world technology frontier, and the scope for its technology imports has been diminishing.

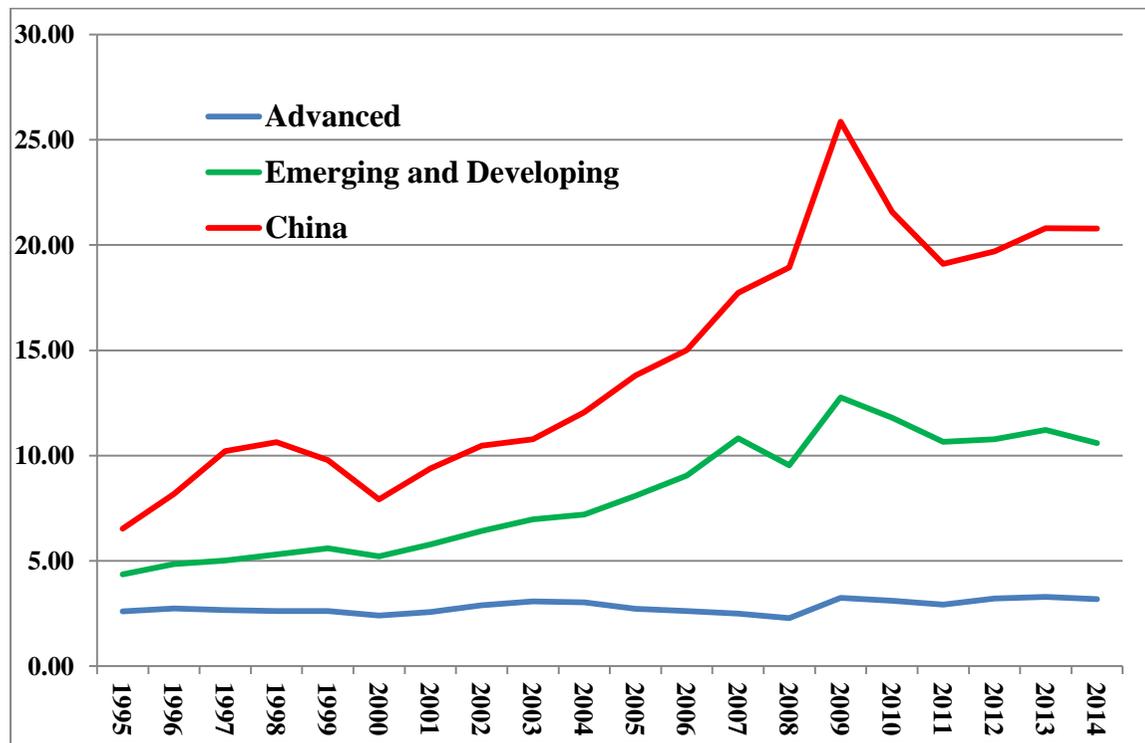
Meanwhile, in a world economy of rising predominance of speculative finance, China has had to push forward financial liberalization as necessary conditions for Yuan internationalization.

China has become a top trading economy in the world, but the role of the Renminbi Yuan in the international monetary system has remained modest. Hence, like other developing economies but being at the extreme, China has had to bear the burdens of excessively accumulating official reserves of foreign exchange (Figure 4). This accumulation is not just costly and risky; it also severely circumscribes the scope for constructing its distinctive model of transformation.

There arises the question as to in what way China could push forward Yuan internationalization and, in relation to it, the actual forms of financial expansion. It is of crucial importance whether this to crowd-out productive investment, or rather to subsume finance under production.

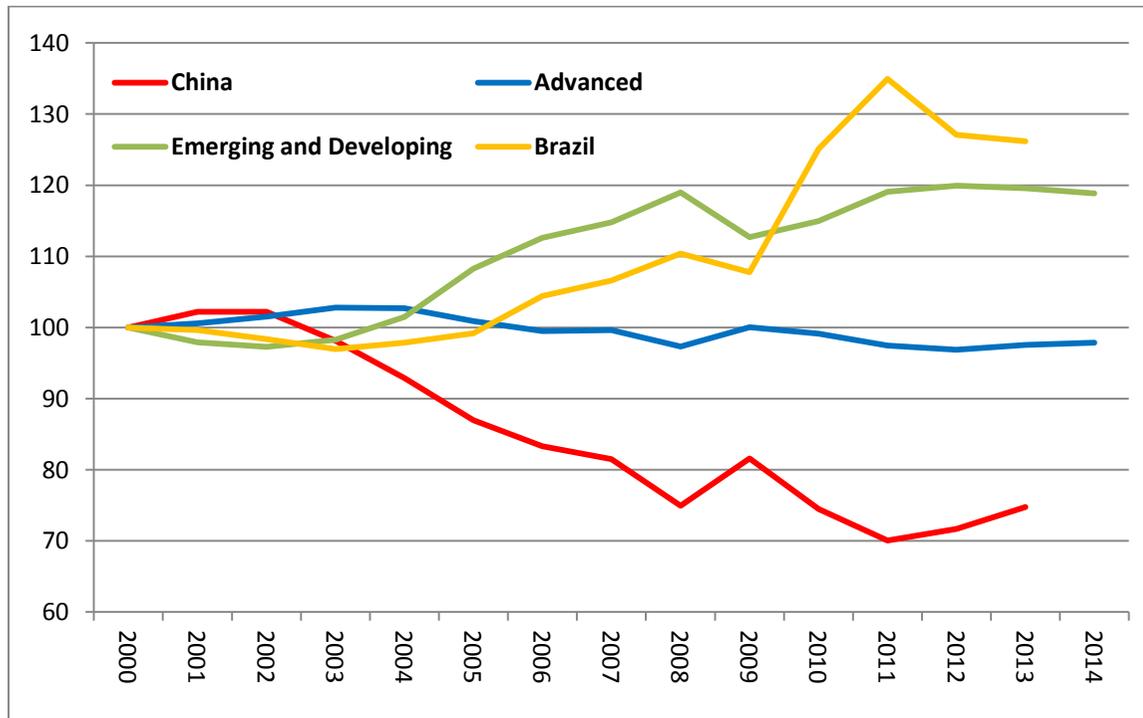
The initiatives and strategies associated with Going-out – “One-belt, One-road”, the AIIB, the New Development Bank, etc. – could be seen in this light. They reflect attempts to tie up Yuan internationalization, and the related financial expansion, with productive investment.

Figure 4. Ratio of official reserves to payments for goods and services import (months)



Sources: IMF, COFER and *International Financial Statistics*, accessed 17 May 2015.

Figure 5. Net Barter Terms of Trade in Goods and Services (2000 = 100)



Sources: IMF *World Economic Outlook*, and World Bank *World Development Indicators*, accessed 17 May 2015.

If this orientation is successfully realized, there is a good chance that Chinese economic transformation and the Going-out initiatives will serve as a countervailing force to financialization worldwide.

Against this background, the rest of the developing world – Latin American economies in particular – could expect to continue to see commodity booms in the future, particularly in connection with the China-initiated infrastructural construction worldwide.

Whether or not this will help to promote true development – including re-industrialization – in Latin American economies depends on (a) the terms of trade between them and China, and (b) the capability of their domestic political economy in overcoming Dutch-Disease-type hindrances to social and economic development. Thus far, the situation has seemed to be positive regarding (a) (**Figure 5**). The situation seems far less optimistic regarding (b), though.

**(Thank you. Comments welcome.)**