Zhang Jun: Why China must save less

China's rapid investment-led growth in recent decades has been fueled by high levels of national savings, but this unbalanced development path appears increasingly risky. The country must now reduce its excessive savings by shifting to a model focused on domestic consumption and opening up the service and non-trade sectors writes Zhang Jun

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In his influential 1954 article "Economic Development with Unlimited Supplies of Labour," the future Nobel laureate economist Arthur Lewis concluded that "the central problem in the theory of economic development is to understand the process by which a community which was previously saving and investing 4 or 5 per cent of its national income or less, converts itself into an economy where voluntary saving is running at about 12 or 15 per cent of its national income or more." That process, Lewis argued, "is the central problem because the central fact of economic development is rapid capital accumulation (including knowledge and skills with capital)."

Lewis's insight is highly relevant to China's rapid investment-led growth in recent decades. But China's growth has been based on much higher levels of national savings than Arthur could ever have imagined. And now this development has become unbalanced and appears increasingly

risky. In a reversal of the process that Lewis described, China must now find a way to reduce its excessive savings by moving to an economic development model based more on the sheer size of its domestic consumption.

This would represent a major shift. For 30 to 40 years, China has relied on export-led industrialization to sustain rapid economic progress. Like Japan and other fast-growing East Asian economies before it, China successfully channelled its high savings into investment in export-oriented manufacturing. And as surplus labour continued to move within China from agriculture to export sectors, the savings rate continued to increase.

Like Japan and other small, fast-growing East Asian economies, while manufacturing exports boomed, domestic service and non-tradable sectors (including telecoms and finance) were highly protected and suppressed in China. The level of this protection was usually unnecessarily high. Such a structurally unbalanced strategy kept the shares of labor income and domestic consumption in GDP relatively low. This led to an ever-increasing Chinese trade surplus, especially with the United States, and a rising risk of trade frictions or even trade wars.

About 15 years ago, China, under enormous pressure from the US and other leading Western countries to reduce its trade surplus, was forced to expand substantially its spending on investment in domestic infrastructure and housing and let the renminbi appreciate, thereby making its exports more expensive. As a result, China's trade surplus has fallen from a peak of around 8.6% of GDP a decade ago to near-balance today.

But China has paid a heavy price for this rebalancing adjustment. Although a surge in infrastructure investment can help to reduce excessive savings, too much of it can lead to macroeconomic volatility and fragile "razor-edge" growth. And this is what has happened. Before the 2008 global financial crisis, China's economy had already been drifting on an unhealthy growth trajectory. Since then, it has gone further in the wrong direction, with accelerating credit expansion pushing investment in the construction of infrastructure and real estate to record highs.

After more than a decade of continuously increasing domestic investment, China now faces accelerated deterioration in total factor productivity and return on capital. GDP growth is slowing because of deteriorating productivity, and will almost certainly not return to previous levels. Worse still, the country has accumulated huge macro and credit risks that will limit future investment growth.

All of this suggests that China's high-saving, high-investment growth model of recent decades has run its course. The right course now would be to rely on a development model that lowers the country's excessive savings. Japan's failure to take a similar step led to the eventual collapse of its asset-price bubble in the early 1990s. Yet, even now, China does not seem to recognize the urgency of reducing its savings, despite the huge significance for its long-term growth prospects.

China needs to shift the focus of its development model from exports to its huge domestic market of 1.4 billion people, which will require opening up the service and non-tradable sectors to foreign and private domestic investors in order to expand supply. Because these sectors have been suppressed and protected for decades, their productivity remains relatively low. But China has enormous market potential in telecoms, health care, social security, education, entertainment, finance, and insurance. The huge purchasing power already released in the country's mobile

Internet sector highlights the wisdom of liberalizing these other sectors.

Doing so would boost productivity significantly, because China's domestic market is large enough to accommodate many competitors in a sector. That, in turn, would create sustainable employment to compensate for job losses caused by the structural shift away from export-oriented manufacturing. More importantly, opening up the domestic-market-based non-tradable sectors would help to increase consumption demand and inhibit excessive savings, thereby helping to improve investment returns.

China is at a pivotal point in its economic development. For decades, it successfully adopted the investment- and export-led growth strategy of small East Asian economies, and it has yet to take full advantage of its size. As the risks of this unbalanced model become increasingly apparent, China's growth must rely more on demand from its domestic market, and less on its industrial capacity and exports. This is the smart way to manage the country's savings, and it is the key to winning any trade war with the US.

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Author

Alissa Lefebre
Economist
alissa.lefebre@ing.com

Deepali Bhargava
Regional Head of Research, Asia-Pacific
Deepali.Bhargava@ing.com

Ruben Dewitte
Economist
+32495364780
ruben.dewitte@ing.com

Kinga Havasi
Economic research trainee
kinga.havasi@ing.com

Marten van Garderen
Consumer Economist, Netherlands
marten.van.garderen@ing.com

David Havrlant
Chief Economist, Czech Republic
420 770 321 486
david.havrlant@ing.com

Sander Burgers
Senior Economist, Dutch Housing
sander.burgers@ing.com

Lynn Song
Chief Economist, Greater China
lynn.song@asia.ing.com

Michiel Tukker
Senior European Rates Strategist
michiel.tukker@ing.com

Michal Rubaszek
Senior Economist, Poland
michal.rubaszek@ing.pl

This is a test author

Stefan Posea
Economist, Romania
tiberiu-stefan.posea@ing.com

Marine Leleux
Sector Strategist, Financials
marine.leleux2@ing.com

Jesse Norcross
Senior Sector Strategist, Real Estate
jesse.norcross@ing.com

Teise Stellema
Research Assistant, Energy Transition
teise.stellema@ing.com

Diederik Stadig
Sector Economist, TMT & Healthcare
diederik.stadig@ing.com

Diogo Gouveia
Sector Economist
diogo.duarte.vieira.de.gouveia@ing.com

Marine Leleux
Sector Strategist, Financials
marine.leleux2@ing.com

Ewa Manthey

Commodities Strategist
ewa.manthey@ing.com

ING Analysts

James Wilson
EM Sovereign Strategist
James.wilson@ing.com

Sophie Smith
Digital Editor
sophie.smith@ing.com

Frantisek Taborsky
EMEA FX & FI Strategist
frantisek.taborsky@ing.com

Adam Antoniak
Senior Economist, Poland
adam.antoniak@ing.pl

Min Joo Kang
Senior Economist, South Korea and Japan
min.joo.kang@asia.ing.com

Coco Zhang
ESG Research
coco.zhang@ing.com

Jan Frederik Slijkerman
Senior Sector Strategist, TMT
jan.frederik.slijkerman@ing.com

Katinka Jongkind
Senior Economist, Services and Leisure
Katinka.Jongkind@ing.com

Marina Le Blanc
Sector Strategist, Financials
Marina.Le.Blanc@ing.com

Samuel Abettan
Junior Economist
samuel.abettan@ing.com

Franziska Biehl
Economist, Germany

Franziska.Marie.Biehl@ing.de

Rebecca Byrne
Senior Editor and Supervisory Analyst
rebecca.byrne@ing.com

Mirjam Bani
Sector Economist, Commercial Real Estate & Public Sector (Netherlands)
mirjam.bani@ing.com

Timothy Rahill
Credit Strategist
timothy.rahill@ing.com

Leszek Kasek
Senior Economist, Poland
leszek.kasek@ing.pl

Oleksiy Soroka, CFA
Senior High Yield Credit Strategist
oleksiy.soroka@ing.com

Antoine Bouvet
Head of European Rates Strategy
antoine.bouvet@ing.com

Jeroen van den Broek
Global Head of Sector Research
jeroen.van.den.broek@ing.com

Edse Dantuma
Senior Sector Economist, Industry and Healthcare
edse.dantuma@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

Rico Luman
Senior Sector Economist, Transport and Logistics
Rico.Luman@ing.com

Jurjen Witteveen
Sector Economist
jurjen.witteveen@ing.com

Dmitry Dolgin
Chief Economist, CIS

dmitry.dolgin@ing.de

Nicholas Mapa
Senior Economist, Philippines
nicholas.antonio.mapa@asia.ing.com

Egor Fedorov
Senior Credit Analyst
egor.fedorov@ing.com

Sebastian Franke
Consumer Economist
sebastian.franke@ing.de

Gerben Hieminga
Senior Sector Economist, Energy
gerben.hieminga@ing.com

Nadège Tillier
Head of Corporates Sector Strategy
nadege.tillier@ing.com

Charlotte de Montpellier
Senior Economist, France and Switzerland
charlotte.de.montpellier@ing.com

Laura Straeter
Behavioural Scientist
+31(0)611172684
laura.Straeter@ing.com

Valentin Tataru
Chief Economist, Romania
valentin.tataru@ing.com

James Smith
Developed Markets Economist, UK
james.smith@ing.com

Suvi Platerink Kosonen
Senior Sector Strategist, Financials
suvi.platerink-kosonen@ing.com

Thijs Geijer
Senior Sector Economist, Food & Agri
thijs.geijer@ing.com

Maurice van Sante

Senior Economist Construction & Team Lead Sectors
maurice.van.sante@ing.com

Marcel Klok
Senior Economist, Netherlands
marcel.klok@ing.com

Piotr Poplawski
Senior Economist, Poland
piotr.poplawski@ing.pl

Paolo Pizzoli
Senior Economist, Italy, Greece
paolo.pizzoli@ing.com

Marieke Blom
Chief Economist and Global Head of Research
marieke.blom@ing.com

Raoul Leering
Senior Macro Economist
raoul.leering@ing.com

Maarten Leen
Head of Global IFRS9 ME Scenarios
maarten.leen@ing.com

Maureen Schuller
Head of Financials Sector Strategy
Maureen.Schuller@ing.com

Warren Patterson
Head of Commodities Strategy
Warren.Patterson@asia.ing.com

Rafal Benecki
Chief Economist, Poland
rafal.benecki@ing.pl

Philippe Ledent
Senior Economist, Belgium, Luxembourg
philippe.ledent@ing.com

Peter Virovacz
Senior Economist, Hungary
peter.virovacz@ing.com

Inga Fechner

Senior Economist, Germany, Global Trade
inga.fechner@ing.de

Dimitry Fleming
Senior Data Analyst, Netherlands
Dimitry.Fleming@ing.com

Ciprian Dascalu
Chief Economist, Romania
+40 31 406 8990
ciprian.dascalu@ing.com

Muhammet Mercan
Chief Economist, Turkey
muhammet.mercan@ingbank.com.tr

Iris Pang
Chief Economist, Greater China
iris.pang@asia.ing.com

Sophie Freeman
Writer, Group Research
+44 20 7767 6209
Sophie.Freeman@uk.ing.com

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

James Knightley
Chief International Economist, US
james.knightley@ing.com

Tim Condon
Asia Chief Economist
+65 6232-6020

Martin van Vliet
Senior Interest Rate Strategist
+31 20 563 8801
martin.van.vliet@ing.com

Robert Carnell
Regional Head of Research, Asia-Pacific
robert.carnell@asia.ing.com

Karol Pogorzelski
Senior Economist, Poland

Karol.Pogorzelski@ing.pl

Carsten Brzeski
Global Head of Macro
carsten.brzeski@ing.de

Viraj Patel
Foreign Exchange Strategist
+44 20 7767 6405
viraj.patel@ing.com

Owen Thomas
Global Head of Editorial Content
+44 (0) 207 767 5331
owen.thomas@ing.com

Bert Colijn
Chief Economist, Netherlands
bert.colijn@ing.com

Peter Vanden Houte
Chief Economist, Belgium, Luxembourg, Eurozone
peter.vandenhoute@ing.com

Benjamin Schroeder
Senior Rates Strategist
benjamin.schroder@ing.com

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

Gustavo Rangel
Chief Economist, LATAM
+1 646 424 6464
gustavo.rangel@ing.com

Carlo Cocuzzo
Economist, Digital Finance
+44 20 7767 5306
carlo.cocuzzo@ing.com