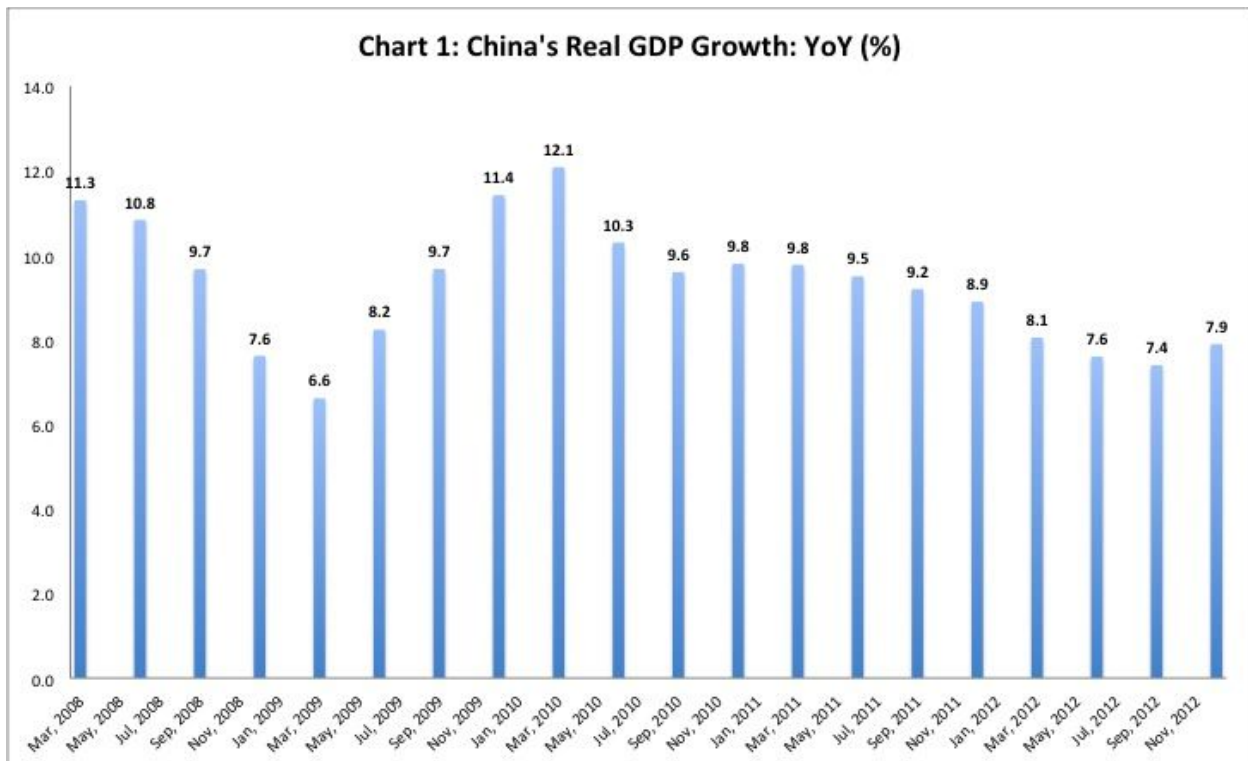


Is China Changing?

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While still at the top of the GP growth table, the Chinese economy seems to be on a long-term traverse from a trajectory with extremely high growth rates to one where growth is more moderate. According to the National Bureau of Statistics (NBS), Chinese GDP growth, year-on-year, which had fallen from 8.1 per cent in the first quarter of 2012, to 7.6 per cent in the second and 7.4 per cent in the third quarter, had bounced back to 7.9 per cent in the last quarter of that year. But the good news may not be this sign of revival, but rather that GDP growth rates in China seem to be in long-term decline. As Chart 1 shows, growth spiked in China when the government launched a \$585 billion stimulus package in response to the 2008 crisis, which drove the year-on-year quarterly growth rate from 6.6 per cent in the first quarter of 2009 to 12.1 per cent in the first quarter of 2010. An important source of that acceleration in GDP growth was a spike in debt-financed construction activity at the provincial level, facilitated by an easy credit policy encouraged by the government.



The deceleration in growth began when the government decided that the rise in growth rates had gone too far. In a two step process starting in the second quarter of 2010, year-on-year quarterly growth rates have fallen from 12.1 per cent in the first quarter of 2010 to below 10 per cent between quarters ending September 2010 and September 2011, below 9 per cent in the subsequent two quarters and below 8 per cent in the last three quarters of 2012. China's annual rate of GDP growth of 7.8 per cent in 2012 was also among the lowest it had registered in 13 years.

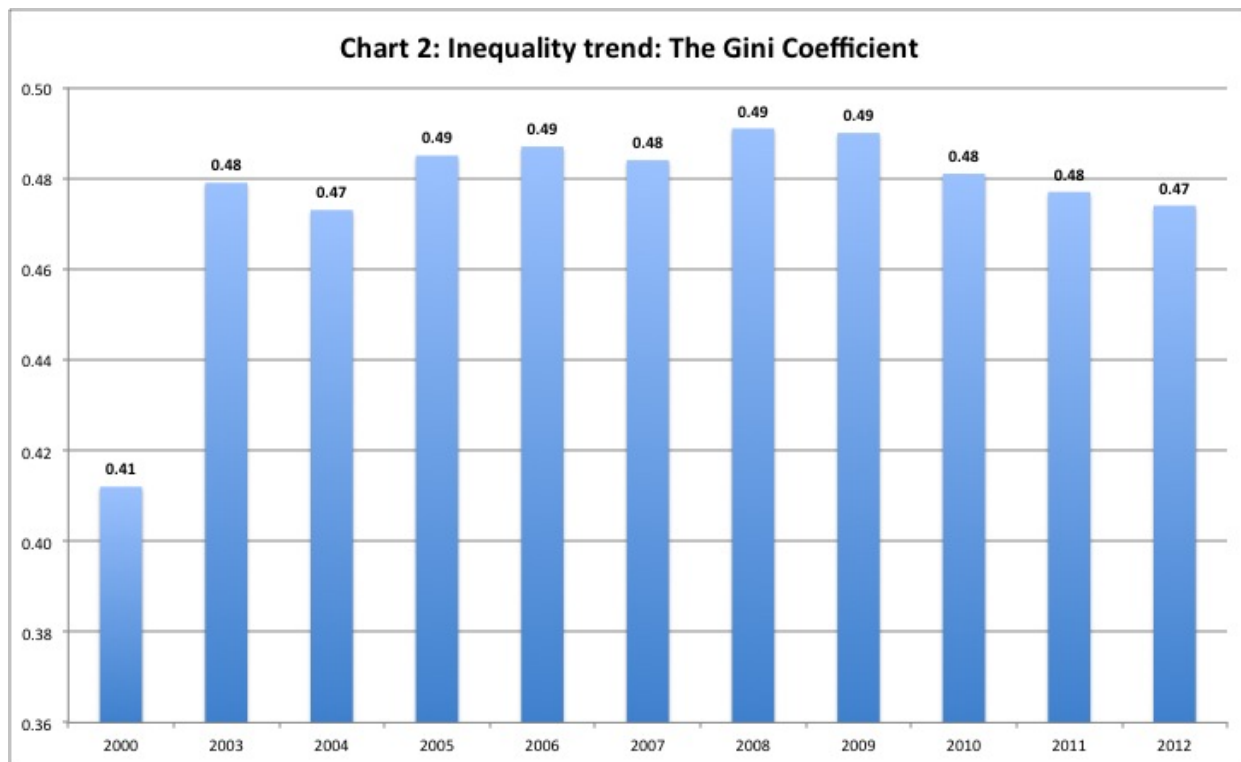
One reason why slowing growth seems positive in China's case is because high rates of growth were seen as being associated with overheating, reflected in a combination of bouts of consumer price inflation and a housing price bubble. Periodically the government had to rein in demand through administrative measures that curbed bank lending and investment expenditures by public sector corporations. However, the problem being structural, and linked to investment decision-making and financing in China, recurred once central government surveillance was relaxed, necessitating another round of administrative intervention. The long term slow down may be indicative of the beginnings of successful structural adjustment to address the problem.

An indication that this transformation is underway is partly provided by data showing that the importance of investment in driving GDP growth has been declining while the role of consumption has been increasing. With investment contributing more than 50 per cent of GDP in recent times, China had emerged as the classic instance of an economy with excess investment, where investment was not induced by perceived market demand and not demand constrained to the same degree as in a conventional capitalist economy. According to the Financial Times (October 18, 2012) "The ghost cities, empty apartment buildings and unused convention centres that dot the country are the physical manifestations of this excessive investment, and investors remain concerned that much of it will translate into bad debts for the banking sector."

Now there is evidence of a shift from investment to consumption. Data from the NBS indicate that during 2011 and 2012 consumption expenditure contributed 56 per cent and 52 per cent of growth respectively, while investment contributed 49 and 50 per cent. The global recession had resulted in a negative contribution of 4 and 3 per cent from net exports. These figures compare with an 88 per cent contribution of investment, 50 per cent of consumption and a negative 37 per cent from net exports in 2009. The Chinese government that has been making a strong case for "rebalancing" growth welcomes this shift to consumption as the principal stimulus to growth.

Evidence suggesting that this trajectory was unsustainable was also coming from the financial sector with incomplete data pointing to a major role for credit from China's version of the "shadow banking" sector in financing investment, housing and construction boom. Shadow finance varies from credit from loan sharks to small and medium businesses to investments in real estate and "prestige projects" of provincial governments with funds mobilised through financial trusts and wealth management products marketed by banks to rich investors. Since these investments promise high returns the projects involved are risky and unlikely to yield promised returns. The resulting instances of financial failure are forcing the government to rein in this activity as well, since estimates of the volume of investments made with "shadow finance" vary from 25 to 50 per cent of GDP. With regulation turning stricter, a slowdown of investment and growth is inevitable.

The reversal of the trajectory of high growth driven by excess investment has another positive side to it. According to figures on inequality (measured by the Gini coefficient which varies from 0, reflecting a situation of complete equality, and 1, or extreme inequality, with just one person in the population having all the income) released by the Chinese government for the first time (Chart 2), inequality rose when growth was high and fell when it slowed. This may be because measures to reduce inequality divert resources away from investment or because reduced inequality favours consumption over investment. In either case the outcome implies significant welfare gains.



According to an article in the online edition of the People's Daily, "China's first release of the Gini coefficient for the past decade demonstrated the government's resolve to bridge the gap between the rich and poor." Though, the Gini has been falling, it is at 0.474, well above the red line of 0.4 set by the United Nations. According to Ma Jiantang, director of the NBS, "The statistics highlighted the urgency for our country to speed up the income distribution reforms to narrow the wealth gap." If that happens consumption may rise and growth slows further. But China's new leadership seems to think that is the way to go. Slower growth may be upsetting the Indian government, but it seems to be a sign of achievement in China.

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