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China's great rebalancing: Promise and peril

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Some encouraging signs indicate that China's new leadership is serious about moving from an investment to a consumption model.

Every March, coverage of the annual session of China's National People's Congress (NPC)—the country's equivalent of the US Congress, though without the filibusters and fiery speeches—saturates the media. This year's NPC was significant: March 14th formally marked the country's once-per-decade transition of power, this time from President Hu Jintao and Premier Wen Jiabao to Xi Jinping and Li Keqiang, respectively. Yet just a day later, another event with huge implications unfolded to little front-page coverage. The Wuxi subsidiary of Suntech Power, one of the world's largest producers of solar panels, defaulted on a bond payment of more than $500 million. The company, once praised and feared by Western analysts, went into technical bankruptcy.

The woes of Wuxi Suntech and its counterparts in other industries exemplify the massive policy challenges that will confront China's new leaders in the next decade. These challenges can be distilled into one statistic: household consumption accounts for only around 38 percent of China's gross domestic product. To put the facts another way, consumers have not begun picking up the economy's slack, as they must if they are to fuel economic growth now that the country's investment-led model is reaching its limits. Chinese household consumption as a share of GDP is barely half that of the United States,

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where it typically accounts for about 70 percent of economic activity, and significantly less than the prevailing rate (approaching 60 percent in recent years) of other large economies, such as Brazil, France, Germany, and India.

China's solar-panel industry is illustrative because it's a classic example of massive investment outstripping demand. In barely a decade, the industry went from nowhere to a position of dominance: the ten largest Chinese manufacturers today account for more than 60 percent of global solar-panel production. The problem is that this growth was almost entirely production driven—in 2010, 96 percent of solar panels made in China were exported; in 2011, 88 percent. Banks showered these private-sector companies with loans as part of a post-2009 stimulus program, and that led to oversupply and sharply lower margins. China also has accumulated massive capacity in state-owned heavy industries, only to discover periodically that such an investment-heavy strategy is both economically and environmentally unsustainable. Environmental crises are increasingly common, income inequality is widening, and the use of cheap credit and state-driven subsidies has sharply accelerated the country's debt levels, leading to fears of potential financial distress.

As the government acknowledges, China's economy must rebalance by reducing its reliance on investment and increasing consumption. Doing so while maintaining growth and stability requires both economic and political changes. We already have some preliminary evidence that economic ones are under way; political changes are harder to forecast, but the probability is certainly higher than it was in the past. Firms and executives must consider the likelihood of changes on both fronts when crafting China strategies for the next decade. That means understanding the likely promise—and peril—of China's great rebalancing.

The economic-policy adjustment has one objective: shifting China from a production-oriented economy to one centered around household consumption. On this front, the country's leadership has already taken some tentative but encouraging steps. Earlier this year, for example, Beijing released a plan to raise the dividend payouts of state-owned enterprises and to use a portion of the distribution to strengthen social-security funds. The plan still requires approval, but its disclosure suggests that there is a realistic possibility it will be implemented and help to curb the investment appetite of state-owned companies while shifting wealth to Chinese households.

Two other policy moves are worth noting and, if implemented, would indicate that China's leadership no longer favors the investment-driven growth model. First, the Ministry of Finance proposed a carbon tax, to be rolled out in the next two years, which, while modest, signifies that the government is serious about addressing environmental concerns. Taxing and raising the price of fossil fuels will not only curb the capital expenditures of Chinese firms but also give them and households an incentive to embrace renewable-energy sources.

On that front, the State Grid Corporation of China has started buying—in extremely modest quantities—electricity from distributed-generation facilities such as solar units operated by households. This year, the National Energy Administration increased its solar-energy-supply target for 2015 by 67 percent. The significance of these developments lies not so much in their magnitude as in the changed policy direction they signal.

The second policy move relates to removing or reducing the implicit subsidies embodied in low energy prices. Production subsidies stealthily transfer wealth from households to firms, reinforcing the production and capacity-building biases of the Chinese system and supporting less competitive companies (including many state-owned enterprises) that would otherwise struggle to invest and grow. This move may reflect a fresh willingness on the part of the country's new leadership to rethink the role of state-owned companies as part of the effort to pivot toward a consumption-based, people-centered model of economic growth. In short, it's another hopeful sign that China's leadership both understands the imperative to rebalance and is beginning to take some concrete steps to do so.

Of course, there is no guarantee that rebalancing will succeed. Part of the problem is that the politics associated with it—boosting the income of Chinese households at the expense of state-owned companies and other large investment-oriented entities—is actually more complicated than the economics. But one thing is certain. China is rapidly reaching the point of diminishing economic and political returns from its investment-driven model, which is headed for change one way or another: either through a proactive rebalancing, with reforms and policy adjustments, or a forced rebalancing precipitated by rising stresses in and beyond the financial system. So far, the signs are encouraging that the new leadership is serious about changing China's growth model, and this is reason enough for global firms that have benefited from China's investment boom to rethink their strategies for the years ahead. o

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