Financial Times
February 20 2007

China does not need a new growth engine

By James Riedel

The old adage –"if it ain't broke, don't fix it" – does not seem to apply to economic growth in China. In spite of China's record-setting growth rate over the past 25 years, it is widely argued that it relies too much on fixed investment as an engine of expansion.

Some analysts say China should rely more on technological change, which, unlike investment, is not subject to diminishing returns. Others suggest that domestic consumption should replace investment as the growth engine. Some say China relies too much on exports, the alleged culprit being an exchange rate policy that keeps its currency "undervalued".

Studies of the sources of China's growth invariably find that it has derived mainly from investment and that technological change has played hardly any role. Anyone who has visited China is likely to be surprised by these findings since technological change is abundantly visible everywhere. So why do these analysts not observe it in the data? The answer is that their measurements proceed on the assumption that investment and technological change are independent of each other, when in fact they are part of the same thing. How do companies in China improve technology if not by investing in new machinery and equipment, much of it imported? In a labour-surplus economy such as China's, employment growth and structural shifts are also dependent on investments that create new jobs.

Growth depends not only on the level of investment, but also on its efficiency, which in turn depends on the quality of economic infrastructure, broadly defined. The most glaring weakness after 25 years of reform is the financial sector, which still does not allocate savings to investments as efficiently as it must do if China's high growth rate is to be sustained.

The argument that China should rely more on domestic consumption is equally misleading and also stems from a misunderstanding of the role of investment. Investment is one component of aggregate demand, along with domestic consumption and net exports. Cyclical fluctuations in any of the components can influence capacity utilisation and hence the growth rate in short-run. In the long-run, however, only investments that expand capacity and raise productivity generate growth. No matter what the source of aggregate demand in the long-run, without investment there is no growth.

Arguing that China should increase domestic consumption is tantamount to arguing that it should save less, hence invest less and – other things being equal – grow more slowly.

There are many good reasons why Chinese households and businesses save more than counterparts in other countries, including: impact of the one-child policy; the desire to accumulate wealth on the part of households that 25 years ago had no private wealth at all; and the shortcomings of the financial system, which imposes a cash-in-advance constraint that forces households and businesses to accumulate savings to finance large transactions.

In these circumstances, the prudent policy is to give the Chinese better access to the financial system and better incentives and then let them decide for themselves what the appropriate level of saving and consumption is.

The argument that China relies too much on external demand has less to do with the growth rate than the exchange rate. Real appreciation of the currency would not necessarily lower saving, investment or growth, nor for that matter would a real depreciation of the dollar against the renminbi have the reverse effects in the US, as American officials seem to think.

Real appreciation of the renminbi is almost inevitable, if not through adjustment of the nominal exchange rate then through inflation, as it will become increasingly difficult in the future to sterilise, or offset, the monetary effect of foreign reserve accumulations. But a move to a freely floating exchange rate must wait until the financial system is overhauled.

Does China need a new growth engine? The answer, in a word, is no. What it needs is a new and improved financial system. It needs many other things as well – better governance and less corruption, a stronger social safety net and greater environmental protection – but reforming the financial system is the one thing government can do readily.

The writer is professor of international economics, Johns Hopkins University School of Advanced International Studies. His book How China Grows: Investment, Finance, and Reform, written with Jing Jin and Jian Gao, will be published by Princeton University Press this year