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# Rebalancing China's Economic Growth: Some Insights from Japan's Experience\*

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## Abstract

One of the greatest challenges China faces is how to reshape its heavily investment-driven mode of economic growth. By investigating how the rebalancing of Japan's economic growth mode was realized in the 1970s, we indicate that it is essential in the rebalancing to correct the distortions in the factor cost (labor cost and capital cost) in a harmonious way. In addition, we refer to Japan's experience to indicate that achieving domestic rebalancing does not necessarily lead to external rebalancing.

Keywords: China, Japan, Rebalancing, Factor Cost Distortion, Current Account Imbalance.

JEL Classification: E21, E22, E25, O11, O53.

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# 1 Introduction

China's economic achievement over the past three decades is doubtlessly one of the most outstanding of our time. China has maintained high growth for more than three decades since the "reform and opening-up policy" it launched in 1978. Economic reforms carried out thereafter were integral factors in the nation's high economic growth. In 2010, China surpassed Japan to become the second largest economy in the world. China is also the largest contributor to world economic growth since 2007. It is projected by some that in one or two decades China will overtake the United States and become the world's largest economy, if its relatively rapid growth is maintained.

However, there are also serious concerns that China may be unable to sustain its current mode of economic growth much longer, as well as arguments that China should not seek to sustain such growth given the side effects. Due to the Chinese economy's impact on the global economy, the issue of how China can sustain its growth is of great interest, not only for China and its citizens but also for the world.

The mode of China's growth is characterized typically by the demand-side components of GDP. China's growth has been heavily driven by investment, and such "excessive" investment-driven growth has side effects, which eventually may grow too large to control if China fails to rebalance its economic growth. The Chinese government clearly recognizes the need to transform its mode of economic development and has already implemented important policy measures to this end. But to date it seems that the progress has been insufficient to substantively rebalance the growth mode.<sup>1</sup> It is no simple task for China to smoothly reshape its growth pattern, considering the complexity of the situation it faces and the potential opposition from those with vested interest in the current economic system.

Let us turn for a moment to Japan. In the early 1970s, Japan transformed its mode of growth from an investment-driven one to one driven in a more balanced manner by investment, consumption, and exports. In the 1970s, the speed of capital accumulation decelerated while consumption continued to increase rapidly as a result of a steady rise in workers' wages. This transformation laid the foundation for Japan to maintain stable growth after the high-growth era of the 1960s. As shown by Fukumoto *et al.* (2010), some basic statistics, such as per capita GDP and the growth rate of the urban population, suggest the likelihood that present-day China is roughly at the same stage of economic development as Japan during or prior to the early 1970s. Although it is not easy to compare the two economies directly, we believe

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<sup>1</sup>In a recent speech at the Boao Forum for Asia on April 15, 2011, President Hu Jintao stated, "China has made remarkable achievements in development, but it remains the largest developing country in the world. Population, resources and the environment have put great pressure on our economic and social development, and there is lack of adequate balance, coordination or sustainability in our development."

that it is worthwhile to draw some insights from Japan’s experience in the early 1970s, when much of Japan’s rebalancing of economic growth was accomplished.<sup>2</sup>

With this in mind, in this paper we try to draw some insights for China from Japan’s experience of transforming its growth mode in the early 1970s. An important previous work in this regard is Minami (1994), who provides a comprehensive comparative analysis of economic development in Japan and China until the late 1980s. In contrast to his study, ours is more contemporary and more focused on the issue of economic rebalancing. To facilitate the comparison, most of our analysis is based on data series that allow direct comparison between Japan and China. Although this study discusses mainly the issue of rebalancing of domestic demand (hereafter, “domestic rebalancing”), we also investigate whether such domestic rebalancing leads to China’s “external rebalancing,” which would mean a reduction in its large current account surplus.<sup>3</sup>

The rest of this paper is summarized as follows. In Section 2, we characterize the current mode of China’s growth and explain why China needs to rebalance its economic growth. In Section 3, we reflect on the rebalancing of Japan’s economic growth in the early 1970s, focusing mainly on how Japan shifted from heavily investment-driven economic growth to that driven by investment and consumption in a more balanced manner. In Section 4, we indicate some insights from Japan’s past experience in the rebalancing of its own economic growth. We also point out important differences between present-day China and Japan in the 1970s, mainly due to institutional factors, and suggest actions China can take to address such factors. In Section 5, we extend our analysis to the external imbalance problem. Drawing from Japan’s experience, we indicate that China’s domestic rebalancing will not necessarily lead to its external rebalancing. Section 6 concludes.

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<sup>2</sup>Some readers may consider that Chinese people should not follow Japan’s path because, since the latter half of the 1980s, Japan experienced the creation and collapse of a bubble economy and the subsequent prolonged stagnation. However, in the analysis of Fukumoto *et.al* (2010), we argue that the current stage of China’s development is much closer to Japan’s 1970s (or even earlier) rather than its late 1980s. Based on this judgment, we consider that Japan’s experience in the 1970s can provide some useful insights to the recent issues of China’s rebalancing (especially, domestic rebalancing). Of course this does not necessarily mean that even in any future China will never face the problem like Japan’s late 1980s and subsequent periods. In this respect, Shirakawa (2011) argues that, as the experience of Japan’s bubble economy suggests, during the transition from high growth to stable growth, a country may face various new challenges, such as (1) preventing bubbles, (2) reviewing business models, and (3) preparing for demographic changes. We do not preclude the possibility that China may face these new challenges in some future day.

<sup>3</sup>In this study, we do not attempt to provide a comprehensive analysis of the background of China’s external imbalance problem (such as exchange rate issues or financial market development). Rather, in Section 5 we briefly examine the relationship between domestic rebalancing and external rebalancing, based on Japan’s experience.

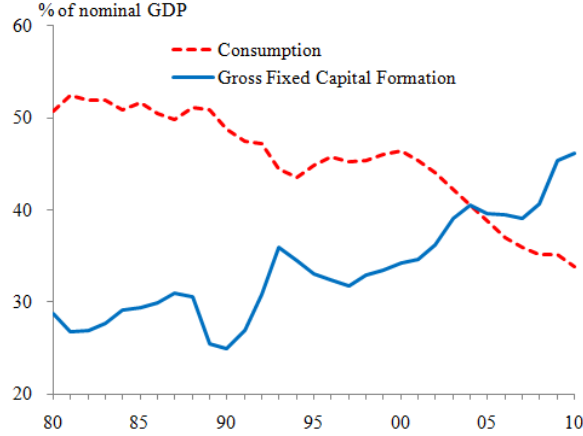


Figure 1: Consumption and Investment in China (as % of nominal GDP)

## 2 Current Mode of China’s Growth and the Need for Rebalancing

The most characteristic feature of China’s economic growth is the dominance of domestic investment. In the 1980s, the ratio of gross fixed capital formation to nominal GDP (hereafter, the investment/GDP ratio) fluctuated around 30 percent (Figure 1). However, following his “South China speech” in early 1992, Deng Xiaoping guided China’s economic reform, stimulating both domestic investment and foreign direct investment.<sup>4</sup> The investment/GDP ratio subsequently trended upward, reaching 46.2 percent in 2010.

	China	Japan	US	Korea	Taiwan	Thailand	Indonesia	India
<b>1. Investment/GDP ratio</b>								
2010 year	46.2	20.5	15.5	28.6	21.7	24.7	32.2	31.8
historical max	46.2	36.4	23.2	38.0	30.9	41.6	32.2	35.8
(year)	(2010)	(1973)	(1943)	(1991)	(1975)	(1991)	(2010)	(2007)
<b>2. Consumption/GDP ratio</b>								
2010 year	33.8	58.6	70.6	52.5	58.0	53.7	56.7	61.9
historical min	33.8	52.3	49.5	49.1	47.2	53.2	56.7	61.7
(year)	(2010)	(1970)	(1944)	(1988)	(1986)	(1995)	(2010)	(2009)

Source: U.S. Bureau of Economic Analysis, Japan’s Cabinet Office, China’s National Bureau of Statistics, CEIC.

Note: The data of India is fiscal year-based.

Table: Investment and Consumption Ratios across Countries

<sup>4</sup>From January 8 to February 21, 1992, Deng Xiaoping made his famous South China tour, inspecting Wuchang, Shenzhen, Zhuhai, and Shanghai. During his trip, he delivered an important speech, which guided and accelerated the reform and opening up of China’s economy while avoiding ideological conflict.

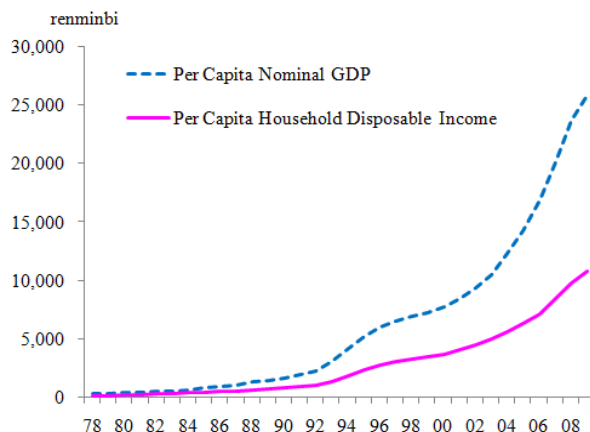


Figure 2: Per Capita GDP and Per Capita Disposable Income in China

In general, emerging countries tend to have a high investment rate during a period of rapid growth, since the return on capital tends to be high because of low capital accumulation. Similarly, China has enjoyed a high return on capital. However, no other emerging country has experienced such a high investment rate (Table). On the flip side, the ratio of private consumption to nominal GDP (hereafter, the consumption/GDP ratio) has been declining and stood at 33.8 percent in 2010, the lowest among major emerging countries. Based on these facts, many analysts feel that it is becoming increasingly difficult for China to sustain its current mode of economic growth.<sup>5</sup>

What is the logic behind the argument that China needs to rebalance its economic growth? Drawing on previous studies, we can summarize below the following conditions that suggest why the current mode of economic growth should be altered.

First and foremost, under the current mode of growth, households have not sufficiently received the benefits of growth. As shown in Figure 2, per capita urban household income has not risen as rapidly as per capita GDP (Aziz and Cui [2007]). The governor of the People’s Bank of China, Zhou Xiaochuan, has observed that the vast majority of Chinese laborers failed to share in the rising profits of the corporate sector (Zhou [2009]). As a result, China’s labor share has been declining. Although the living standard of the Chinese people has certainly improved, it has not improved in line with the growth of GDP.

Second, the current pattern of growth has created fewer urban jobs than a more labor-intensive pattern. Investment-driven economic growth has made China’s in-

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<sup>5</sup>He and Kuijs (2007) developed a growth scenario that broadly incorporates the features of past growth and extrapolates them into the future through 2035. Their result suggests that if China continues its rapid growth under the current mode, its rates of investment would need to increase to 50 to 60 percent of GDP in the decades ahead.

dustries increasingly capital-intensive. As pointed out by Kuijs and Wang (2006), capital-intensive industries create fewer jobs than labor-intensive ones such as service industries. To boost employment, the development of the service sector, supported by the growth of consumption, is necessary.

Third, investment-driven growth has led to a slowdown in productivity growth. Lardy (2007) argues that the deceleration of total factor productivity growth since the early 1990s, which is reported by Kuijs and Wang (2006), can be attributed at least partly to overinvestment and excess capacity in several important industries, such as steel.

Fourth, with investment-driven growth, it is quite difficult to improve energy efficiency and reduce damage to the environment. China has been beefing up efforts to make its economy more energy-efficient and environmentally friendly. However, investment requires machinery and equipment, so that investment-driven growth by its nature consumes comparatively more energy.<sup>6</sup>

The Chinese government is very mindful of the need for China to rebalance its economic growth, and several relevant measures have been put into practice. The 11th Five-Year Plan (2006-10) declared that China must adjust its proportion of investment and consumption and reasonably control the size of investment, as well as increase the contribution of consumption to economic growth.

However, in reality, during the period of the 11th Five-Year Plan, the investment/GDP ratio rose further, while the consumption/GDP ratio declined. Although it could be argued that unexpected factors such as the 2008 Wenchuan Earthquake and the global financial crisis hindered China's progress, to offset the negative impacts of these events the Chinese government initiated a massive economic stimulus mainly by boosting public investment. In the short term, this measure was inevitable to prevent China from plummeting into recession. Nevertheless, as a result the investment/GDP ratio rose even higher, rendering China's economic development more disproportionate.<sup>7</sup>

Thus, to date we have not found sufficient progress in the rebalancing of China's economic growth, even though its necessity is widely acknowledged. Given the challenges China faces, it is important to understand the kind of adjustment process required for the rebalancing of economic growth. In this respect, we believe that it is beneficial to analyze how rebalancing was accomplished in Japan. Below we elaborate on this point.

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<sup>6</sup>In its mid-term report on China's 11th Five-Year Plan, the World Bank (2008) pointed out, "Without rebalancing the pattern of growth and the economic and industrial structure, it is unlikely that the 20 percent reduction target in energy intensity could be achieved." In fact, the Chinese government did not achieve the target (the actual reduction in energy intensity was 19.1 percent) although it introduced some sector-specific measures to reduce energy consumption.

<sup>7</sup>An eminent Chinese economist, Wu Jinglian, has stated his concern that judging from the situation from 2009 to 2010, the transformation of the economic development mode has progressed very little and may actually have worsened (Wu [2011]).

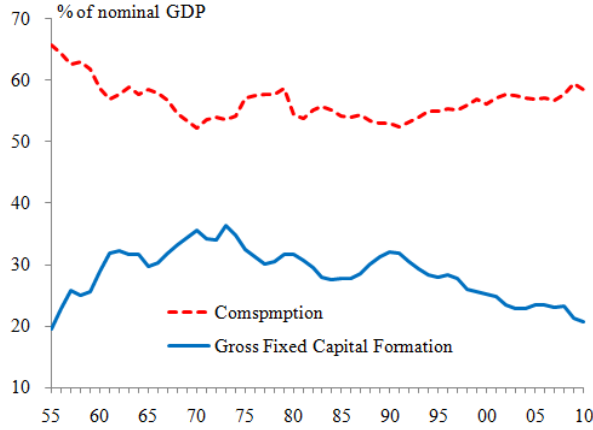


Figure 3: Consumption and Investment in Japan (as % of nominal GDP)

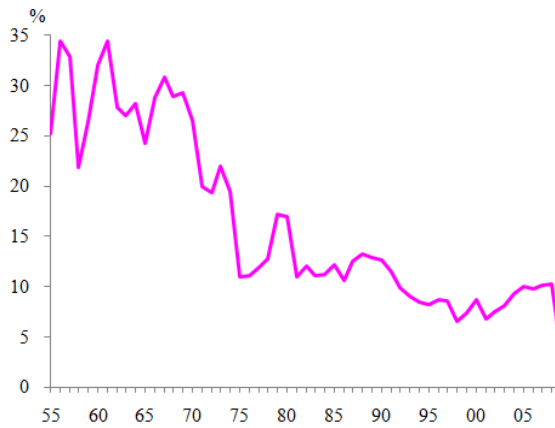


Figure 4: Return on Capital in Japan

### 3 Rebalancing of Japan's Domestic Growth

From 1955 to 1970, Japan achieved high economic growth with an average GDP growth rate of 9.7 percent. Similar to present-day China, the high growth during this period was initiated by vigorous investment. The investment/GDP ratio trended upward, while the consumption/GDP ratio decreased (Figure 3). However, the decline in the consumption/GDP ratio and the rising trend in the investment/GDP ratio clearly halted in the first half of the 1970s. In retrospect, it is apparent that the early 1970s was the period when Japan achieved its rebalancing.

What were the main factors behind this rebalancing? The most apparent one is the decline in the return on capital. Figure 4 shows a series for the return on capital, calculated using the method of Bai, Hsieh, and Qian (2006).<sup>8</sup> During the high-growth

<sup>8</sup>Strictly speaking, our calculation method differs slightly from Bai, Hsieh, and Qian (2006) in



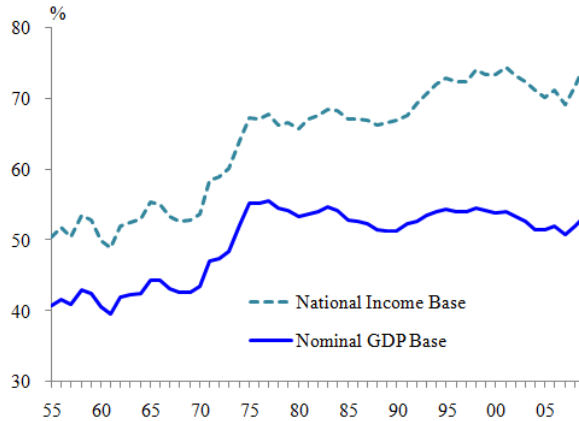


Figure 5: Labor Share in Japan

period, the return on capital was higher than 20 percent. In the early 1970s however, it dropped sharply and never returned to its previous high level.

The decline in the return on capital was basically caused by the slowdown in the productivity growth of capital. There are a number of reasons for this slowdown. On the supply side, the process of catching up to advanced foreign technology, which was a major driving force during Japan’s high-growth period, was virtually complete around the early 1970s (Kosai [1986]). On the demand side, the consumption boom in durable goods, brought about by massive population inflows into urban areas, also concluded as urbanization drew to a close (Yoshikawa [1995]). Consequently, in the early 1970s the return on capital decreased substantially, and this significantly reduced firms’ incentives to maintain high investment. This was the basic background for the decline in the investment/GDP ratio in the early 1970s.

However, we can point out two other important elements that played crucial roles in Japan’s rebalancing. The first is the rise in the labor share of income. Figure 5 shows that the labor share accomplished a rapid increase of more than 10 percentage points in only five years (1970-75). The rise of the labor share was triggered by high inflationary pressure due to the 1973-74 oil crisis, which promoted wage growth. However, the point is that the rise in the labor share during this period became permanent rather than temporary.

During the high-growth period, because of the existence of the surplus labor in the farm village, the level of real wages fell below labor productivity as shown in the Lewis model (Lewis [1954]). However, according to Minami (1973), the Lewis turning point had already been reached in the 1960s, and rising pressure on real wages had increased due to the disappearance of surplus labor. In such circumstances after the mid-1960s, workers’ sense of entitlement to their “fair share” rose, as shown in

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that it does not include net production tax in the numerator of the capital share. See the Appendix.

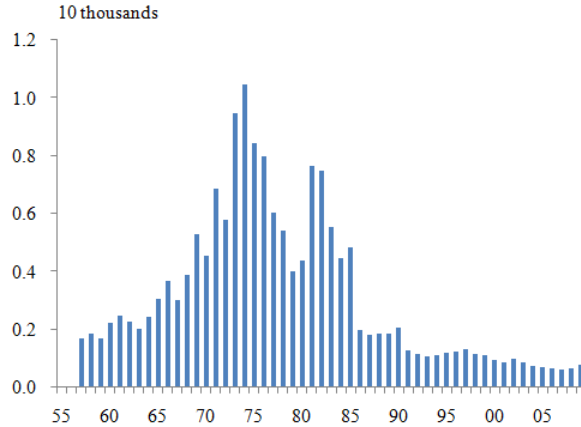


Figure 6: Number of Labor Disputes in Japan

the increase in labor disputes (Figure 6), and their bargaining power strengthened. Consequently, it became difficult to restrain the rise in real wages again after the end of the oil crisis, and the rise in the labor share became permanent (Yoshikawa [1994]). Through this process, real wages caught up with the productivity level.<sup>9</sup> This adjustment contributed greatly to the increase in household disposable income.<sup>10</sup> As a result, the declining trend in the consumption/GDP ratio was curtailed.

The second important element in Japan's rebalancing was the narrowing of the difference between the return on capital and the cost of capital. Because Japanese firms typically raise funds through bank lending, the cost of capital can be approximated by the bank lending rate. Since the financial liberalization was not accomplished before the 1980s, the bank lending rate was highly regulated until the 1970s, as is the present-day China. A comparison of the return on capital and the bank lending rate in the period before the 1970s shows that the latter was set far below the former (Figure 7). This suggests that the low cost of capital was one of the key causes of the investment boom during the high-growth period. However, the monetary tightening during the period of the oil shock and the aforementioned decline in the return on capital significantly reduced the difference between the return on capital and the lending rate in the first half of the 1970s. This means that the cost of capital rapidly

<sup>9</sup>Strictly speaking, the rise in the labor cost during this period was caused by an increase in welfare expenses and salary payments related to research and development (Inoue and Nishimura [2004]). In other words, the rise in the labor share during this period reflected the improvement in workers' bargaining power vis-à-vis labor conditions in a broad sense.

<sup>10</sup>It is true that the increase in household income was at least partially caused by the Japanese government's postwar policies aimed at protecting agriculture and farmers (such as agricultural land reforms and price supports for agricultural products), which yielded serious agricultural problems such as excessive rice production. However, the rise in the labor share was observed in a broad range of industries, particularly in the manufacturing sector (Inoue and Nishimura [1994] and Yoshikawa [1994]). Accordingly, we judge that the rise in the labor share was more important for the increase of Japan's total household income.

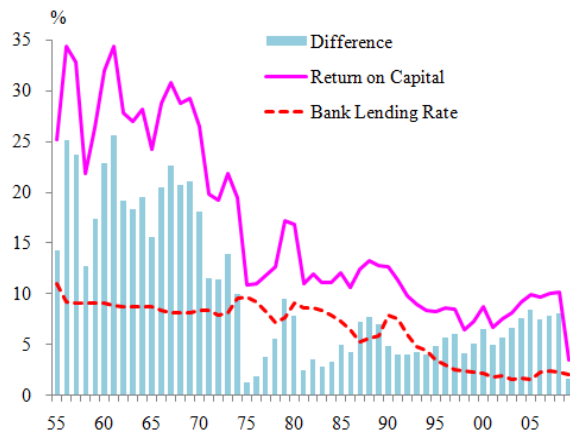


Figure 7: Return on Capital and Cost of Capital in Japan

approached the return on capital during the period.<sup>11</sup>

This adjustment can be viewed as another important factor in the rebalancing. As explained above, the distortion in the labor cost was corrected in the early 1970s. In such an environment, if the cost of capital had been kept low, capital would have been relatively cheaper than the labor for private-sector firms. This would have made it hard to reduce firms' incentives to maintain their high investment. Consequently, the accomplishment of rebalancing would have been difficult.

## 4 Insights from Japan's Experience and Caveats

### 4.1 Corrections of Factor Cost Distortions

In the previous section, we explained the process of Japan's rebalancing of economic growth. In doing so, we stressed the importance of two elements: (1) the rise in the labor share; and (2) the narrowing of the difference between the return on capital and the cost of capital. Our key point here is that to accomplish the rebalancing, cost distortions concerning labor and capital should be corrected in a harmonious way.

We believe that the same argument is applicable to present-day China. Figure 8 indicates that China's labor share was kept at low level, especially after the mid-2000s. This may be because the increase in workers' real wages has lagged the increase in labor productivity (Figure 9). However, in more recent years, real wage growth seems to be in the process of catching up with labor productivity growth. Because of this movement, China's labor share has begun to rise in recent years.

<sup>11</sup>Takeda (1985) estimates the *effective* bank lending rate, by taking account of the deposits held by borrowers. His results suggest that the effective rate was higher than the face rate. However, his findings also imply that the difference between the return on capital and the cost of capital shrank rapidly in the early 1970s, even if the effective rate was used as the measure of the cost of capital.

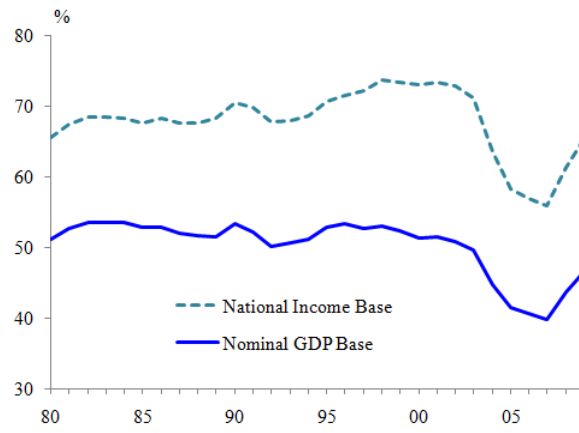


Figure 8: Labor Share in China

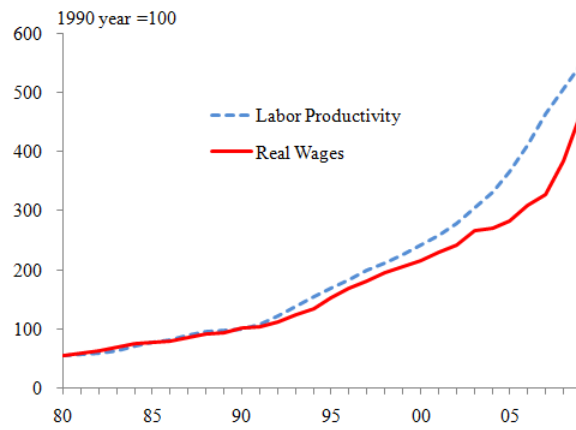


Figure 9: Labor Productivity and Real Wage in China

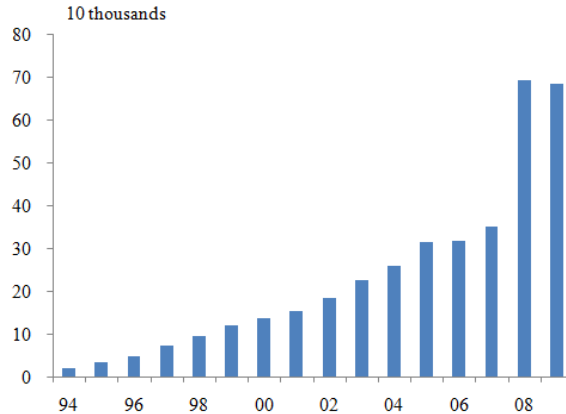


Figure 10: Number of Labor Disputes in China

What is the background to the recent rise in China’s labor share? One potential factor is the reduction of the amount of surplus labor in rural areas. An important question here is whether or not the Lewis turning point had been reached in China. In the recent literature, this issue is highly controversial.<sup>12</sup> Because analyses differ greatly in terms of data or empirical strategies, it is difficult to derive a decisive conclusion. In addition, since many of the previous studies use data until the mid-2000s, it is even harder to judge whether the turning point was reached in the late 2000s. However, as suggested by Knight, Quheng, and Shi (2011), because of labor market segmentation due to restrictions on rural-urban labor migration (which we will discuss later), it is possible that upward pressures exist on real wages (especially in urban areas) even if the Lewis turning point has not been actually reached.

Another background factor to the increase of real wages is the enhancement of workers’ awareness of labor rights, triggered by institutional reforms in China’s labor market. Since the Labor Contract Law was enforced in January 2008, the number of labor disputes has been surging. The government ordered each employer to make contracts with its employees; as a result, the number of labor disputes accepted by judicial courts reached 700,000 in 2008 (Figure 10). In 2010, when local governments raised minimum wages that legally bound employers, labor disputes surged again. Labor unions, which in the past tended to support employers, have started playing a more important role in enabling employers and employees to reach agreement.

These movements resemble the case of Japan in the early 1970s. Based on the

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<sup>12</sup>By investigating various statistics on the rural labor force, Cai and Wang (2008) suggest that the turning point is approaching in recent China. Zhang et.al (2010) use the micro-level wage data in six provinces and conclude that the turning point in China has already arrived in 2003. In contrast, Minami and Ma (2010) claim that the turning point was not yet passed (at least in the first half of the 2000s) by comparing the marginal productivity and the real wage in China’s agricultural sector. Although we cannot list all other related studies, some recent analyses are provided by Du and Wang (2010), Wang (2010), and Garnaut (2010), for instance.

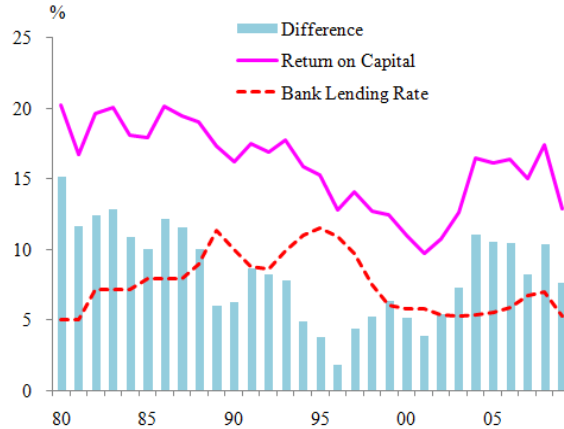


Figure 11: Return on Capital and Cost of Capital in China

experience of Japan, China should see to it that labor movements smoothly promote the steady growth of real wages and contribute to enhancing workers' living standards. This would lay the foundation for a rise in the consumption/GDP ratio.

The other important point is that the cost of capital should be closer to the return on capital when real wages catch up with the productivity of labor. In the case of China, interest rates have been regulated far below the return on capital (Figure 11). The difference between the return on capital and the bank lending rate broadened in the 2000s. The cheap cost of capital has been one of the causes of the increase in the investment/GDP ratio in the 2000s. Looking ahead, if China fails to narrow the gap between the cost of capital and the return on capital when the cost of labor rises significantly, the cost of capital compared to that of labor will become cheaper and industries will naturally become more capital-intensive, which is contrary to the government's objective announced in its Five-Year Plan.

#### 4.2 Caveats: Differences between China Today and Japan in the 1970s

We have indicated two key elements from the experience of Japan's domestic rebalancing in the early 1970s. However, in considering how China can rebalance its economic growth, we should also bear in mind several differences between the two countries. China, for example, has unique problematic institutional factors that have lowered its consumption/GDP ratio. Addressing such institutional problems is also necessary for China to rebalance sufficiently its economic growth. Below, we indicate two such problems.

##### (1) Public Spending on Education, Health Care, Housing, and Pensions

As discussed earlier, the investment/GDP ratio in China is much larger than that

in Japan in the 1970s. We believe the difference stems in part from the institutional reforms that China implemented in the late 1990s. The reform of state-owned enterprises (SOEs) began in the late 1990s, when the SOEs laid off a massive number of employees. SOEs were freed substantially from the burden of paying for employees' housing, education, health care, and pensions. As a consequence, the labor share declined. At the same time, the consumption/GDP ratio dropped partly because the laid-off employees spent less and partly because workers needed to save money for future expenses such as housing, education, health care, and pensions. Chamon and Prasad (2010) find that the household saving rate rose because the expenses of education, health care, and housing became a new burden on households after the SOE reform. To boost the labor share and thus raise consumption, therefore, beefing up only the bargaining power of workers may be insufficient. The government should expand public spending on housing, education, and health care and devise a sustainable reform of public pensions.

## (2) The *Hukou* System and the Government Land Purchase System

During the high-growth period in Japan, many rural migrant workers settled in urban areas and started families. This movement boosted consumption in urban areas. Moreover, rural farmers near urban areas obtained generous amounts of money by selling their land to real estate developers. In these ways, the urbanization process increased Japanese households' income significantly and supported strong growth in consumption. However, urbanization in China has differed greatly from Japan in this regard, in that it has not added substantially to the wealth of households. Key factors behind this result are the *Hukou* system, China's unique registration system, and the government's land purchase system.

Under the stringent *Hukou* system, Chinese rural migrants enjoy little public support for education, health care, and pensions in the urban areas where they live. Accordingly, very few rural migrants are able to settle in urban areas and start families. Huang (2010) found that China's urbanization has improved the income position of rural migrant workers substantially but may have increased their precautionary saving motivation, because the public support they receive in cities is quite limited.<sup>13</sup>

In addition, because of the government's land purchase system, the current urbanization process is unfavorable to rural households. Local governments typically earn income through real estate development by expropriating land from farmers at a cost approximating the land's agricultural productive value, and then selling it to real estate developers at the value of an urban district. Thus, the benefit of urbanization accrues much more to local governments and developers than to farmers.

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<sup>13</sup>According to his survey, saving rates of rural migrant workers in Guangzhou and Shenzhen were above 40 percent, much higher than urban *Hukou* residents of 16 percent and 27 percent in 2007.

Reform of the *Hukou* system and the government's land purchase system will enable household income and consumption to grow more vigorously.

## 5 Does Domestic Rebalancing Lead to External Rebalancing?

As we have seen in the preceding sections, Japan's experience suggests that to achieve the rebalancing of domestic economy, it is essential to correct the distortions in factor cost (labor cost and capital cost) in a harmonious way.

In a recent study, Huang and Wang (2010) and Huang and Tao (2011) insist that correcting factor cost distortions is a fundamental solution to the imbalance problem in China. The former stress that "the root cause of the imbalance problem lies in factor cost distortions, which were again a result of the asymmetric reform approach: complete liberalization of the product markets and heavily distorted factor markets. These distortions are like producer or investor subsidies. They boost corporate profits but reduce household income" (Huang and Wang [2010], p. 15). With respect to the rebalancing of domestic economy, our view is fairly close to theirs.

However, they claim further that the correction of factor cost distortions contributes to the reduction of not only the domestic imbalance but also the external imbalance. They provide their own measures of factor cost distortions and show that the measures are highly correlated with China's current account surpluses between 2000 and 2009. Based on this evidence, Huang and Tao (2011) claim that "factor market distortion leads to unusually large external imbalances, especially large trade surpluses and current account surpluses. The cost distortion improves exporters' profitability and exports' competitiveness in the international markets" (Huang and Tao [2011], p. 12).

Here, we investigate whether this kind of argument is supported by Japan's experience. As we have already explained, the distortions in factor costs were corrected on both sides – labor and capital – through the first half of the 1970s. During this period, the external imbalance did not become a serious problem as the ratio of current account surplus to GDP was at most 2.5 percent in 1971 and the surplus was not long-lasting (Figure 12). However, from the mid-1980s the surplus expanded rapidly, reaching 4.2 percent of GDP in 1986. This indicates that Japan's external imbalance problem became particularly serious after the mid-1980s, when a large part of the factor cost distortions was already eliminated.

This experience tells us that the correction of factor cost distortions does not necessarily contribute to the reduction of the external imbalance. Of course, China is not necessarily moving along the same path as Japan in all respects. However, Japan's experience is strong at least as a counterexample to the view that domestic rebalancing contributes to the achievement of external rebalancing.



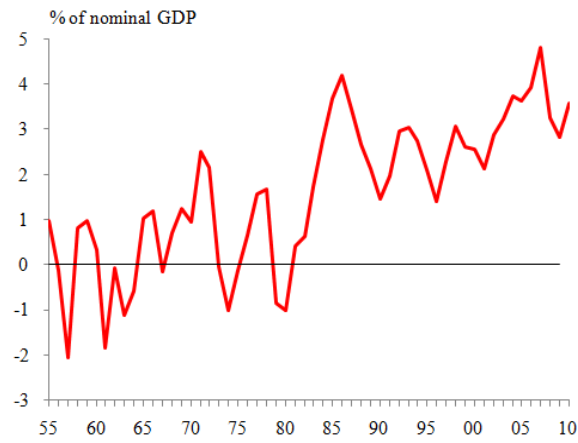


Figure 12: Current Account Balance in Japan

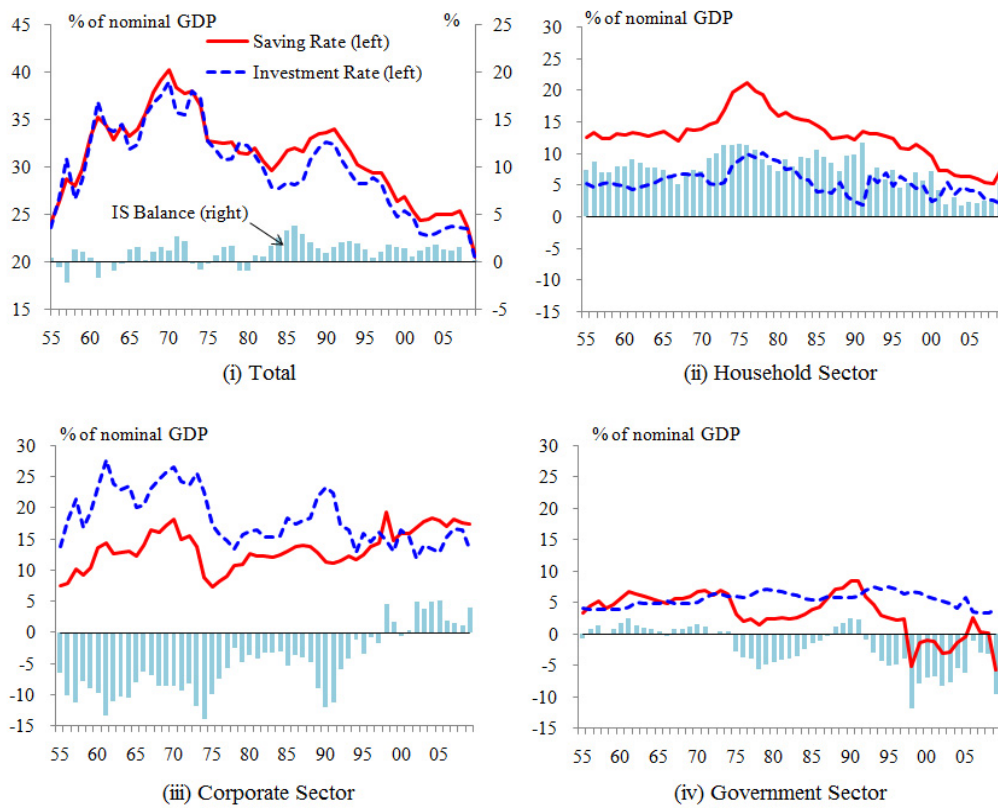


Figure 13: IS Balance in Japan

To gain a better understanding of Japan’s external imbalance problem, the conventional “IS balance approach” is useful (Figure 13). The economy-wide saving rate traced a downward trend from the first half of the 1970s. However, since the drop in the investment rate after the mid-1970s was more rapid than the decline in the saving rate, the current account surplus expanded. In sectoral levels, particularly important movements are (1) the sharp decline in the investment rate in the corporate sector since the early 1970s and (2) the rapid rise in the saving rate in the government sector in the late 1980s. The investment excess in the corporate sector was reduced structurally as a result of the acute impairment of the investment rate due to the rapid decline in the return on capital. Given this background, the saving rate in the government sector increased greatly in the late 1980s, owing to the cyclical increase in tax revenue during the bubble period. These elements brought about a very large current account surplus in the latter half of the 1980s.

When considering the IS balance of the Chinese economy in the future, it is assumed that the investment rate will decrease at some stage if the return on capital decreases due to the slowdown in productivity growth and the deceleration of urbanization. If the pace of decline in the investment rate exceeds that in the saving rate, the current account surplus will expand, as in the case of Japan.

In considering these aspects, it seems that the corrections of factor cost distortions do not necessarily contribute to the reduction of China’s current account surplus (Figure 14), and that various strategies will be needed to influence the decision on saving and investment, especially measures to reduce the saving rate. Comprehensive reforms will be required, such as (1) the enhancement of public support for medical treatment, education, and housing; (2) the enhancement of the public pension system; and (3) the advancement of a domestic financial market.<sup>14</sup>

## 6 Concluding Remarks

This paper investigated how Japan rebalanced its economic growth mode in the 1970s. We indicated that (1) the rise of the labor share and (2) the narrowing of the difference between the return on capital and the cost of capital were the key elements in Japan’s rebalancing of economic growth. This suggests that, in order to accomplish the rebalancing, the factor cost (labor cost and capital cost) distortions should be corrected in a harmonious way. We argue that this finding is applicable to China’s current situation. In addition, in light of the fact that Japan’s current surplus widened after the rebalancing of the growth mode, redressing only factor cost

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<sup>14</sup>Kuijs (2006) examines the potential effects of various factors, including demographic changes, urbanization, corporate dividend policy, financial market reform, and the shift in the composition of government spending. His estimation suggests that the shift in the composition of government spending and financial market reform have a relatively large impact in reducing China’s saving-investment imbalance.

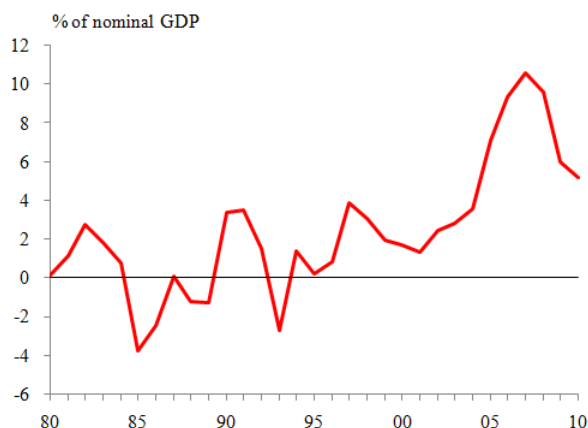


Figure 14: Current Account Balance in China

distortions may not suffice to improve the external imbalance.

If rebalancing is judged necessary, the next question is when China should rebalance its economic growth mode. In this regard, some might consider that Japan's experience shows the rebalancing will take place naturally when the growth potential starts decelerating, and that it is not too late for China to rebalance its economy when the growth rate starts declining. In fact, China's urbanization is expected to slow gradually and China's labor force will stop increasing and begin decreasing at some point in the future. These changes will surely decelerate China's growth potential.

However, we believe that China should start rebalancing right now rather than later. China's growth mode is so disproportionately investment-driven that it may be too late to change its growth mode after the potential growth rate starts declining. China's consumption/GDP ratio is far lower and its investment/GDP ratio far higher than the equivalent ratios in Japan in 1970 and those of other emerging countries currently. Japan was able to rebalance its growth mode relatively smoothly because its dependency on investment was more modest than that of China. In China's case, given the far higher investment/GDP ratio, it may be difficult to rebalance its growth mode as smoothly as Japan did. It would be far easier for China to rebalance its growth mode while maintaining the current high growth. By doing so, China could prevent the side effects caused by the current growth mode, such as slower job growth, from becoming too large to deal with.

The Chinese government seems to recognize the immediate need for rebalancing.<sup>15</sup> The 12th Five-Year Plan (2011-15), approved by the National People's Congress in

<sup>15</sup>In his speech at the Boao Forum for Asia on April 15, 2011, President Hu Jintao stated, "In the next five years, China will make great efforts to implement the strategy of boosting domestic demand, especially consumer demand, and put in place an effective mechanism to unleash consumption potential. We will ensure that consumption, investment and export contribute to economic growth in a coordinated way."

March 2011, states that in the next five years China needs to transform its mode of economic development substantively to one in which consumption, investment, and exports harmoniously sustain economic growth. China changed the target for its annual economic growth from 7.5 percent (2006-10) to 7 percent (2011-15), adding that the quality and efficacy of economic growth needed to be significantly improved.<sup>16</sup>

Although many still prioritize the speed of growth over its quality, we hope that the Chinese government will promptly carry out the measures necessary to contribute to the rebalancing.

## Appendix: Data Description

### A. Japan's Data

GDP, consumption, and gross fixed capital formation used in Figure 3 are from the *National Accounts* published by the Cabinet Office. Concerning the return on capital in Figure 4, we basically follow the method of Bai, Hsieh, and Qian (2006). The formula is given as follows:

$$r_t = \frac{\alpha_t}{P_t^k K_t / P_t^y Y_t} + \left( \widehat{P}_t^k - \widehat{P}_t^y \right),$$

where  $r_t$  is the return on capital,  $\alpha_t$  is the capital share,  $P_t^k$  is the price of capital,  $K_t$  is real capital stock,  $P_t^y$  is the price of output goods,  $Y_t$  is real output, and  $\delta_t$  is the depreciation rate of capital stock. In contrast to Bai, Hsieh and Qian (2006), we do not include net production tax in the calculation of  $\alpha_t$ . We use the series of nominal tangible assets as  $P_t^k K_t$ , nominal GDP as  $P_t^y Y_t$ , the annual growth rate of the deflator of gross fixed capital formation as  $\widehat{P}_t^k$ , and the annual growth rate of the GDP deflator as  $\widehat{P}_t^y$ . All of these data are from the *National Accounts*. The labor share in Figure 5 is calculated as labor remuneration divided by nominal GDP or national income (the sum of labor remuneration and business operating surplus), all of which are from the *National Accounts*. The number of labor disputes shown in Figure 6 is from the *Survey on Labour Disputes* published by the Ministry of Health, Labour and Welfare. The bank lending rate presented in Figure 7 is the long-term prime lending rate of principal banks published by the Bank of Japan. The current account shown in Figure 12 is from the balance of payments data released by the Ministry of Finance and the Bank of Japan. Finally, saving rates (or investment rates) in

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<sup>16</sup>The 12th Five-Year Plan also stipulates that (1) labor compensation should grow at the same pace of labor productivity, (2) household income should increase by 7 percent, and (3) the minimum wage standard should increase by no less than 13 percent on average per year, respectively.

aggregate and sectoral levels presented in Figure 13 are calculated as total saving (or gross fixed capital formation) divided by nominal GDP in the corresponding sectors. These data are from the *National Accounts*.

## B. China's Data

For GDP, consumption, and gross fixed capital formation used in Figure 1, we obtain the series since 1978 from the *China Statistical Yearbook* published by the National Bureau of Statistics (NBS) and the series before 1978 from Hsueh and Li (1999). We calculate per capita household disposable income as the weighted average of per capita urban household disposable income and per capita net income of rural household, which are published by the NBS. As for the weight of this calculation, we use the shares of the urban and rural populations, which are also published by the NBS. The number of labor disputes shown in Figure 8 is from the *China Statistical Yearbook*. The labor share in Figure 9 is calculated as the labor remuneration divided by nominal GDP or national income. These data since 1978 are from the *China Statistical Yearbook* and those before 1978 are from Hsueh and Li (1999). The total number for employment used to calculate labor productivity and real wages is from the *China Statistical Yearbook*. As for the return on capital in Figure 11, we basically follow the method of Bai, Hsieh and Qian (2006), but do not include net production tax in the calculation of the capital share. The bank lending rate in the same figure is the renminbi benchmark loan rate (one year) set by the People's Bank of China. The current account balance in Figure 14 is from the balance of payments data released by the State Administration of Foreign Exchange.

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