



Cost Distortions and Structural Imbalances in China

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Abstract

This paper attempts to explain the fundamental cause of China's growing imbalance problems. Economic data confirm that the key structural imbalance problems, such as overinvestment, large current account surpluses, low consumption share of GDP and income inequality, have all deteriorated over the past few years, despite continuous policy efforts to correct these problems. We argue that the key determining factor is repressed factor cost, which is associated with heavily distorted markets for labor, capital, land, resources and the environment. These are like implicit subsidies for producers, investors and exporters. They boost growth and, at the same time, lift investment and exports. Previous policy efforts have focused more on administrative measures, which have not been sustainable. Therefore, a more fundamental solution to the imbalance problem lies in completing market-oriented reforms for production factors and allowing free markets to determine prices of labor, capital, land and resources.

Key words: cost distortion, production factor, structural imbalance

JEL codes: E010, E250, E510

I. Introduction

When the Wen Jiabao government first took office in early 2003, it was immediately concerned about the quality and the sustainability of the Chinese growth model. In the following years, policy-makers repeatedly warned that the current growth model could not continue given the irrational economic structure, the weak capability of innovation, the overreliance on resource consumption, the worsening of the pollution problem, the widening of regional disparities and the deterioration of income inequality (Wen, 2006).

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This official assessment of the Chinese growth model cuts into the root of the concerns that economists have been voicing for years. For instance, Yu Yongding has been discussing structural imbalance problems since the late 1990s. Two of the most commonly identified problems in his work are high shares of investment and current account surpluses in GDP (Yu, 2007). Overinvestment could signal future excess capacity, and very large external imbalances could substantially weaken the sustainability of China's very strong growth trajectory.

To some external observers, discussion of China's growing risks might appear strange. After all, China is the only country in human history that has successfully achieved 10-percent average GDP growth for more than 3 decades. If the Chinese Government has thus far been able to overcome the obstacles to strong growth, it should be able to do so in the future. China is set to overtake Japan as the world's second largest economy in 2010.

China's economic performance during the current global financial crisis has probably reinforced this impression of the Chinese Government's effectiveness. In late 2008 and early 2009, Chinese growth decelerated sharply as a result of a collapse in exports. However, the authorities quickly turned the economy around through aggressive fiscal and monetary expansion. By early 2010, the economy had already returned to 12-percent growth. Some experts began to warn of inflation and overheating risks.

Since Chinese Premier Wen Jiabao took office in 2003, the government has made a serious effort to correct structural imbalances. It adopted various measures to control investment growth, to reduce export incentives and to boost consumption. Unfortunately, however, almost all imbalance problems have worsened over the past 7 years, despite continuous policy efforts. The investment share of GDP has risen further, the current account surpluses have grown and income inequality has deteriorated sharply.

Accurate identification of the structural imbalances by policy-makers and lack of progress in dealing with these problems in recent years highlight the conflicting assessments by China experts (Huang, 2010b). Some describe the performance of the Chinese economy during the reform period as the "China Miracle" (Lin *et al.*, 1996). If rapid growth continues, China is likely to become the world's largest economy within the next decade or two. However, others focus more on the risk factors and believe that the current reform approach is not sustainable (Pei, 2006). Pessimists have even suggested an imminent collapse of the Chinese economy (Chang, 2001).

It is important to point out that even optimists are concerned about the imbalance problems. The difference between the optimists and the pessimists lies in their confidence that the government should be able to defuse the risks, as it has managed to do many times over the past 30 years. However, this is a very strong assumption. Past performance is often a reliable prelude to future development, but there are also enough examples where

adaptive expectations fall short.

Leaving aside the debate between optimists and pessimists regarding the future of Chinese growth, the present paper aims to address three key issues relating to structural imbalances. First, what are the key imbalance problems and how did they evolve? Second, what did the government do to address these problems and what have been the impacts so far? Finally, what is the fundamental cause of the imbalance problems and how should they be addressed more effectively?

Economists have already proposed different explanations for China's imbalance problems (Huang and Tao, 2010). Some emphasize the unique roles played by the government in pushing for ever stronger economic growth (Yao, 2010). Some point to the undervalued currency, which not only boosts net exports but also discriminates against non-tradable sectors. Others blame the undeveloped social welfare system for causing an under-consumption problem. The real picture is likely the result of all these and other factors.

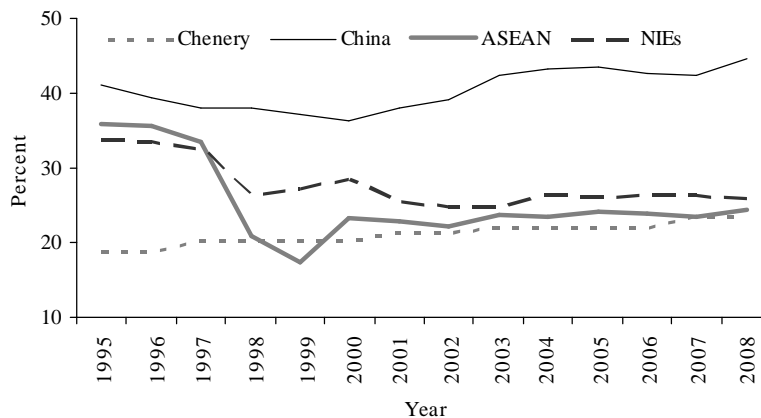
A central argument of the present paper is that China pursued a unique reform approach during the reform period that focused on liberalization of the goods markets. Meanwhile, much of the factor markets remain highly distorted. These distortions generally depress factor prices and, therefore, production costs. They are like producer subsidies or investor subsidies. We argue that these implicit subsidies have contributed to China's very rapid growth during the past 30 years. However, they have also been responsible for many of the imbalance problems. This suggests that elimination of the imbalance problems requires further liberalization of factor markets.

The remainder of the paper is organized as follows. The next section describes the imbalance problems in China, in particular their evolution during the past years. Section III reviews the key policy actions undertaken to reduce the imbalance risk and assesses their effectiveness. Section IV discusses China's asymmetric liberalization approach toward product and factor markets during the reform period and estimates the associated distortions to production costs. The final section concludes the paper by suggesting that completing the transition toward becoming a market economy should be at the center of any policy efforts to rebalance the Chinese economy.

II. Growing Imbalance Problems

Although it is widely agreed that China's economic structure is imbalanced, there is no scientific criteria for measuring the imbalances. In the present paper, we discuss the imbalances relative to the normal ranges of other countries. However, such an approach does have some drawbacks. For instance, the average investment share of GDP for the

Figure 1. Investment Shares of GDP in China, ASEAN and Newly Industrialized Economies (NIEs), 1995–2008



Source: CEIC Data Company and authors' calculation.

Note: The "Chenery Standard" is calculated based on empirical relationship between consumption rate and national income using data from 101 countries (Chenery and Syrquin, 1975).

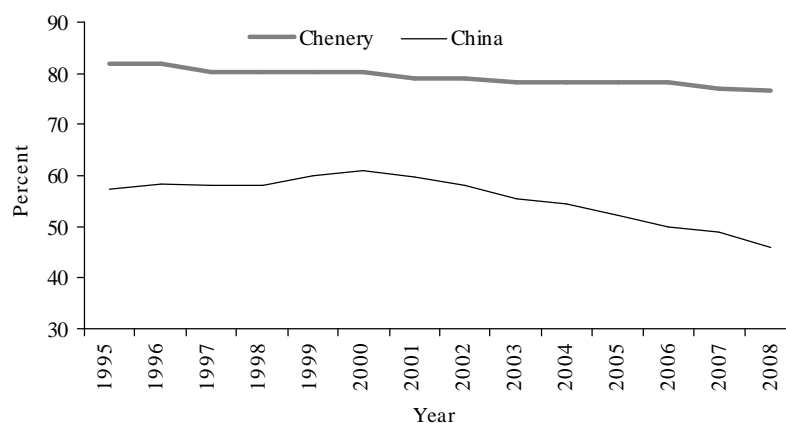
world as a whole is approximately 25 percent, but a 35-percent investment share for China might not be too high, for various reasons. Therefore, in making judgments we also need to look at certain indicators such as investment returns and overcapacity problems.

So, are Chinese investment shares too high? Some economists believed that while China's shares are high, they are nothing abnormal given China's unusually strong growth (Garnaut, 2006). In fact, they argue that when China successfully reduces its current account surpluses, its investment share could go even higher.

Although it is true that China needs investment to drive growth, the current investment share is already unusually high, having risen from 36 percent in 2000 to approximately 45 percent in 2008 (Figure 1). The latest reading is already way above the levels achieved by most ASEAN and newly industrialized economies in the region. The "Chenery Standard," which is based on an empirical relationship among 101 countries, implies a 24-percent investment ratio at the current income level.

Very high investment shares often increase risks of overheating, bubbles and excess capacity. East Asian economies are known for strong economic growth and high investment shares. During the last half of the 20th century only 3 other Asian economies had above-40-percent investment shares. Singapore had close to a 50-percent share in the early 1980s, which collapsed in the mid-1980s. Malaysia and Thailand also had above-40-percent shares in the mid-1990s. However, both economies suffered from financial crises a couple of years later.

Often the other side of too high an investment share is a very low consumption share

Figure 2. Consumption Shares of GDP in China, 1995–2008

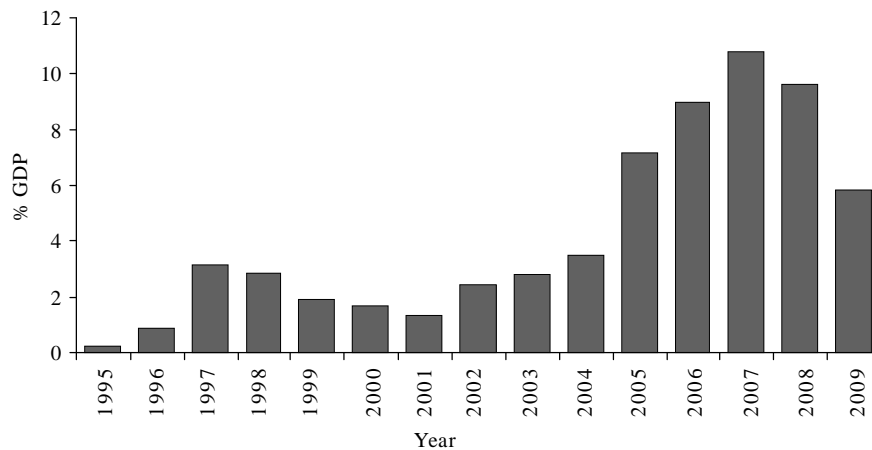
Source: CEIC Data Company and authors' calculation.

Note: "Chenery Standard" is calculated based on empirical relationship between consumption rate and national income using data from 101 countries (Chenery and Syrquin, 1975).

of GDP. The "Chenery Standard" suggests that China's consumption share should still be at around 80 percent. However, the actual reading is approximately 30 percentage points lower (Figure 2). Between 2000 and 2008, the consumption share dropped by 15 percentage points. If this trend continues, the Chinese economy will face a major problem as no economy could sustain simply relying on investment growth. This could even become a political problem because the population does not consume enough.

Perhaps China's best known global imbalance problem is its large current account surplus. In 2000, China's current account surplus was only 1.7 percent of GDP. It dipped slightly the following year. However, as China joined the WTO at the end of 2001, the surpluses began to rise. The most dramatic increases in the current account surplus occurred after 2004. By 2007, the surplus had reached 10.8 percent of GDP. The share of the current account surplus in GDP moderated in 2008 and 2009 as a result of the global crisis (Figure 3). However, whether this fall was permanent or temporary needs to be addressed carefully.

Large current account surpluses could be problematic for China in a number of ways. First, because China maintains a relatively rigid exchange rate regime, the People's Bank of China (PBOC) has had to accumulate foreign reserves. This implies that China, as a middle-income country, lends capital to the rich countries. Second, a large current account surplus means that a significant portion of Chinese growth, often one-third, is dependent on external markets. This necessarily increases macroeconomic instability when the external markets

Figure 3. China's Current Account Surpluses, 1995–2009

Source: CEIC Data Company and State Administration of Foreign Exchange (SAFE).

become volatile. Finally, large current account surpluses also attract criticism from foreign countries and could become a source of excuses for trade protectionism.

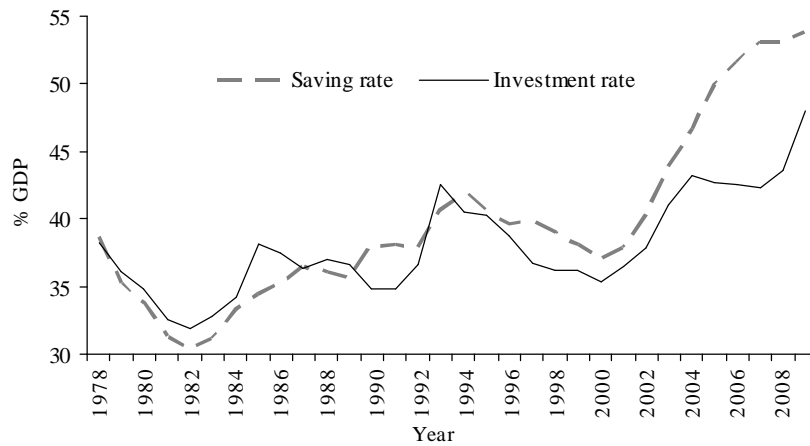
Current account surplus is, by definition, the difference between national savings and national investment. When East Asian economies shifted from current account deficits to surpluses after the Asian financial crisis, it was mainly due to declines in investment (Figure 1). China's story today is quite different. As we mentioned previously, the investment ratio increased by almost 9 percentage points between 2000 and 2008. During the same period, the saving ratio rose by 17 percentage points (Figure 4).

Therefore, understanding saving behavior is crucial for explaining changes in the current account. At the start of this century, the consensus was that households were a key contributor to increases in national saving. One important factor identified for driving this change was the underdeveloped social welfare system. This perception, however, changed a few years ago. Disaggregate data on national savings point to a much more dramatic expansion of corporate savings in the years leading up to 2004 and 2005 (Figure 5). Therefore, changing corporate saving behavior or taxing corporate profits might be more effective in dealing with China's current account problems.

The latest data, again, reveal new changes. Corporate net savings started to decline, while the government's net savings began to increase ahead of the global crisis. Household savings expanded once more.

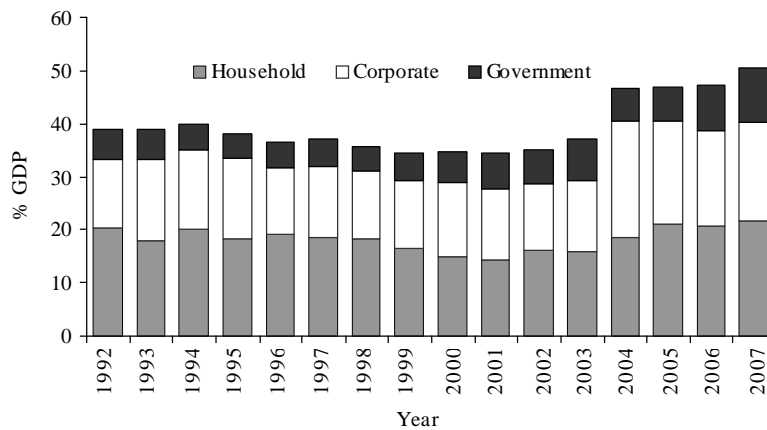
There are many other indicators of structural imbalances, including sector compositions and environmental changes. One very important indicator is income inequality. Despite the government's efforts to support rural development, the urban–rural income ratio

Figure 4. China's Saving and Investment Ratios, 1978–2009



Source: CEIC Data Company and National Bureau of Statistics of China.

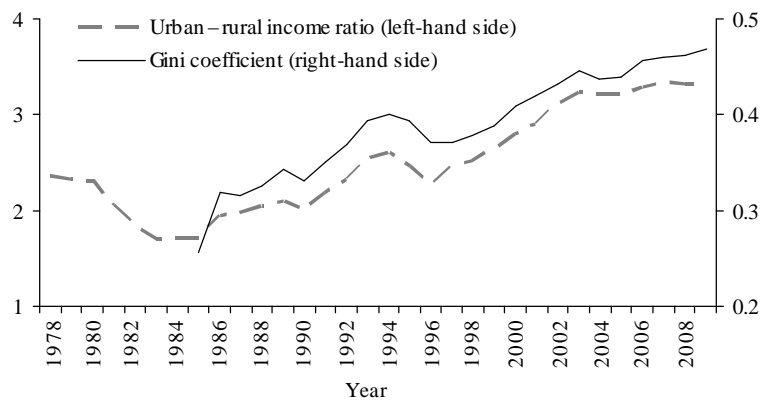
Figure 5. Contribution of Households, Corporate and Government to National Saving in China, 1992–2007



Source: CEIC Data Company and National Bureau of Statistics of China.

increased from a low of 1.7 in 1984 to 3.3 in 2009 (Figure 6). More importantly, the Gini coefficient for household income jumped from below 0.3 in the mid-1980s to close to 0.5 in 2008–2009. This latest reading is among the highest in the world and indicates significant social risks.

Figure 6. Urban–Rural Income Ratio and Gini Coefficient of Household Income, 1978–2009



Source: National Bureau of Statistics of China and authors' compilation.

III. Past Policy Efforts

China's macroeconomic conditions are often regarded as super-stable due to a lack of volatilities. However, the economy does feature distinct cycles from time to time. Since early 2003, the Chinese economy has experienced at least two full cycles. The economy was accelerating in 2003 but started to show signs of overheating in 2004. After a brief period of stabilization, the economy overheated again in much of 2007 and early in 2008. By early 2010, the Chinese economy was already well on the way to recovering from the effects of the global crisis and was exhibiting signs of overheating again.

The Wen Jiabao government set rebalancing of economic structure and transformation of the growth model as its policy priorities when it first took office. Often, policy efforts for macroeconomic adjustments and economic rebalancing are closely interlocked together. Sometimes it is difficult to distinguish one from the other. However, in general, the government is much more serious about rebalancing when attempting to control overheating. Often structural concerns became secondary when trying to boost growth.

The first macroeconomic tightening under the Wen Jiabao government started in 2004. Fixed asset investment grew by 43-percent year-on-year during the first quarter. Led by food prices, the consumer price index also rose steadily from the beginning of the year, crossing the 5-percent warning line of the PBOC in July and August.

The government took a wide range of measures to control the overheating risks. The most important direct steps were designed to slow down investment activity, including:

raising capital requirements for investment projects in iron and steel, cement, aluminum and real estate; eliminating a total of 4813 development zones across the country; tightening land controls for construction projects; terminating 70 600 investment projects nationally; and closing down the steel plant “Tie-Ben” in Jiangsu Province.

The PBOC’s policies were relatively more sector-neutral, including: hiking the reserve requirement by 0.5 percentage points; increasing the base lending rates by 27 basis points; removing ceilings for lending rates; and forcing down loan growth through “window guidance” and “credit quotas.”

Economic policies turned around from early 2005 when the growth of industrial value-added, commercial bank loans and industrial profits all decelerated steadily. As a result, the PBOC eased controls over loan growth.

However, the government continued with its policy efforts to transform the growth model. It closed down a large number of companies with high energy consumption, serious pollution and low production safety standards. It also introduced measures to restructure 11 industries, including steel, coal and cement, and closed down backward production capacities of 110 million tons of coal and 1.2 million tons of aluminum. The central government also required that all provinces reduce energy intensity of GDP by 4 percent and to lower major pollutants by 2 percent by 2006.

In July 2005, the PBOC introduced a breakthrough reform to its exchange rate policy, by abandoning the peg, revaluing the currency, and adopting a managed float with reference to a basket of currencies. In the following 3 years, the renminbi appreciated by 22 percent against the US dollar and by 16 percent in real effective exchange rate terms.

As the policy-makers’ contractionary policy eased, the economy again gathered momentum from early 2006. GDP growth picked up to above 10 percent during the first quarter of the year. In particular, new loans amounted to 1.25 trillion yuan during the same period, more than half of the PBOC’s annual target. The inflation rate picked up more visibly in 2007 and early 2008. This change in macroeconomic conditions again triggered a new round of policy tightening.

The government first lowered or abolished export tax rebates for high energy-consumption, heavy pollution and resource-intensive industries. The National Development and Reform Commission (NDRC) introduced new policy tightening controls over new investment projects and, again, raised the capital requirement for certain construction projects. In the meantime, the government started 10 key energy conservation projects but closed down a large number of factories, including 11 200 coal mines, 46.6 million tons of iron production capacity, 37.5 million tons of steel production capacity and 87 million tons of cement production capacity.

The PBOC raised the reserve requirement ratio a few times between early 2006 and

early 2008. It also hiked the base lending rates several times during the same period. It insisted that commercial banks tighten controls over loan extensions for investment projects. Meanwhile, the Ministry of Finance also transitioned its fiscal policy from a proactive to a neutral stance.

As a result of the effects of the global financial crisis, the Chinese economy abruptly moved downward from mid-2008. Export growth collapsed, the purchasing managers' index plunged and industrial activities, such as power generation, tanked. Real GDP growth fell to 6.7-percent year-on-year during the fourth quarter of 2008 and further to 6.1 percent during the first quarter of 2009.

This time, the policy-makers acted very aggressively. The PBOC cut the interest rate in September 2008 and engaged in extraordinary credit expansion from the fourth quarter of 2008. In 2009, new loans reached 9.6 trillion yuan, almost double the annual target. Currency appreciation against the dollar stopped from mid-2008 and the managed float was replaced by a soft peg to the dollar. In November 2008, the State Council announced a fiscal stimulus package of 4 trillion yuan for spending in the following 2 years. The government also raised export tax rebates seven times from 1 August 2008 to 1 June 2009, focusing on labor-intensive products.

Fortunately, the government did not completely halt efforts to improve the quality of growth. It made new efforts to restructure the telecom and airline industries, although the motivation was not entirely clear. The government closed some small power generators, equivalent to 1669 kW capacity, and 1054 small coal mines. The Ministry of Environmental Protection (MOEP) did not approve a number of new projects from 2009 in order to preserve the environment.

Most significantly, the government released a new policy document "China's Responses to Climate Change: Policy and Action" and announced explicit targets and policy measures to cap greenhouse-gas emission by 2020.

The economy started to move upward from the second quarter of 2009, due to aggressive policy expansion. By early 2010, policy-makers were already actively assessing options for exit of the expansionary policies. The deterioration of the sovereign debt crisis in the Euro Area early that year made the authorities reconsider the timing of halting the expansionary policies.

In retrospect, the government has undertaken a wide range of policy measures to address the imbalance or growth quality problems over the past 6 years. Although it has also utilized measures such as exchange rates, tax rates and capital requirement, most policies have been administrative in nature. The most commonly adopted instruments included the NDRC's approval to shut down projects and the MOEP's veto powers. Considering the past 7 years as a whole, however, the policy efforts taken to rebalance the economy have not achieved the intended results. Almost all indicators for economic imbalances worsened during that period.

IV. Factor Cost Distortions

Why have the imbalance problems deteriorated continuously during the past 7 years, despite repeated policy efforts? One possible explanation is that it takes time for some policies to be effective. For instance, the government tried various means of boosting household confidence and consumption spending by developing the social welfare systems and reducing personal income tax burdens. However this is a gradual process..

A more fundamental explanation is that the government policies did not attack the root cause of the imbalance problems. Economic agents' behavior is driven by the incentive structure, such as household incomes, production profits and investment returns. As Karl Marx once pointed out, when profitability reached above 100 percent, capitalists would be willing to risk their lives. Therefore, as long as investment returns are high, administrative measures might not be sufficient to slow investment activities.

Indeed, distortions to the incentive structure have been a key feature of China's reform approach. China achieved extraordinary GDP growth during the reform period. Although economists have different interpretations of the essence of the reform policies, most agree that letting the market mechanism work is a central element. Replacing the central planning system with the free market has significantly improved both the allocative and the technical efficiency of the economy (Lin *et al.*, 1996).

The market-oriented reform, however, has not been symmetric. After more than 30 years of economic reform, almost all product markets are liberalized, but the factor markets remain heavily distorted. This is true for all production factors, including labor, land, capital, resources and the environment. These distortions significantly affect the incentive structure for producers, investors and exporters. They are largely responsible for the growing imbalance problems (Huang, 2010a; Huang and Tao, 2010).

Labor market distortions are pretty apparent. The most obvious example is the household registration system (HRS). In its early years, the HRS prohibited labor mobility. From the mid-1990s, the HRS was no longer effective in preventing movements of labor as large numbers of farmers started to move into cities. However, these migrant workers are still discriminated against because they are not official urban residents. They are not entitled to the normal urban social welfare benefits. More importantly, migrant workers often only receive half or even one-third of the pay of urban residents, even if they perform the same job functions.

Therefore, the HRS provides an important institution that has enabled urban employers to discriminate against migrant workers. This is particularly so in labor-intensive export sectors. If the employers paid migrant workers all the social welfare contributions and equivalent wages of urban workers, China's export sector might not be as large as it is

today. Others, however, argue that if the countryside has surplus labor, then removal of HRS will not increase labor costs.

Capital market distortions are also obvious. The Chinese financial system possess all the typical features of financial repression: highly regulated interest rates, state-influenced credit allocation, a frequently adjusted statutory reserve requirement and a strictly controlled capital account (Huang and Wang, 2010a, b). Earlier World Bank studies revealed that financial repression often led to lowering of the interest rates by a couple of percentage points. The undervalued cost of capital in China can be confirmed by very wide gaps, often of 8 percentage points or more, between nominal GDP growth potential and long-term government bond yields.

Further evidence of capital cost distortion is the undervalued currency. Although economists disagree on the magnitude of the misalignment, few doubt that the renminbi is undervalued (Goldstein and Lardy, 2008). Clearly, an undervalued currency represses the cost of domestic capital relative to foreign capital. An undervalued currency not only promotes exports and discourages imports but also discriminates allocation in favor of tradables over nontradables.

Distortions in the cost of land are less straightforward. High land prices have repeatedly captured the headlines in the media in China. However, this is normally in relation to land for property development purposes. Land use costs are still extremely low for manufacturing investors. In China, land is owned by the collectives in the countryside but by the state in the cities. The local governments often compete with each other by offering lower land use fees to attract investors to their regions.

Distortions of energy and other resource prices often vary over time depending on the movement of international prices. Taking oil prices as an example, the NDRC adopted a formula linking domestic oil prices with several international prices. Whenever international prices moved by more than 7 percent, domestic prices would be adjusted accordingly. However, when international crude prices moved to above US\$80 per barrel, the NDRC stopped adjusting domestic prices for fear of higher prices disrupting production and consumption.

Finally, if we regard the environment as an input to production, then its cost is also distorted because the implementation of the environmental protection policies is often less than rigorous. In other words, producers in China, whether foreign or Chinese, undercompensate for their pollution.

We should point out that distortions in factor cost are not new in China. In the pre-reform period, China implemented the unified purchase and marketing system (UPMS) for agricultural products. The traditional assessment was that the main objective of UPMS was to ensure a stable supply of agricultural products to the urban areas. Song (1994), however,

points out that the real rationale of UPMS was to transfer resources from agriculture to urban industry.¹ The purpose was to achieve rapid urban industrialization.

The purpose today is probably similar. At the end of 1978, the Chinese leaders shifted their policy priority from class struggle to economic construction. This was revolutionary. Over the years, however, GDP growth gradually became the most important indicator in the assessment of local government officials' performance. Therefore, the government has strong incentives to do whatever it takes to achieve fastest possible growth. Repressed factor prices, like repressed agricultural prices in the pre-reform period, are a way of boosting economic growth.

To gauge the magnitudes of the distortions, we put together a set of estimates based on the initial efforts by Huang and Tao (2010).² Needless to say, these estimates are not scientific results and are, therefore, subject to criticisms. Our main purpose here, however, is to provide a rough picture, not perfectly accurate figures (Table 1). According to this estimation, factor cost distortions increased significantly over the

Table 1. Estimated Factor Cost Distortions in China, 2000–2009 (% GDP)

	Labor	Capital	Land	Energy	Environment
2000	0.1	4.1	0.5	0.0	3.8
2001	0.2	3.9	0.5	0.0	3.5
2002	0.8	3.9	0.4	0.0	3.3
2003	1.0	3.8	1.1	0.0	3.3
2004	2.0	3.1	0.9	0.6	3.0
2005	2.4	3.0	1.3	1.7	3.0
2006	2.7	3.1	2.0	1.6	2.8
2007	3.2	3.6	1.2	1.6	2.4
2008	3.6	3.4	1.0	0.7	1.9
2009*	2.7	3.5	0.9	0.7	1.8

Source: Huang and Tao (2010) and authors' estimation.

¹ Song's article was first written in 1982 when he was an undergraduate student of the Peking University.

² For detailed estimation methods, please refer to the Appendix of Huang and Tao (2010).

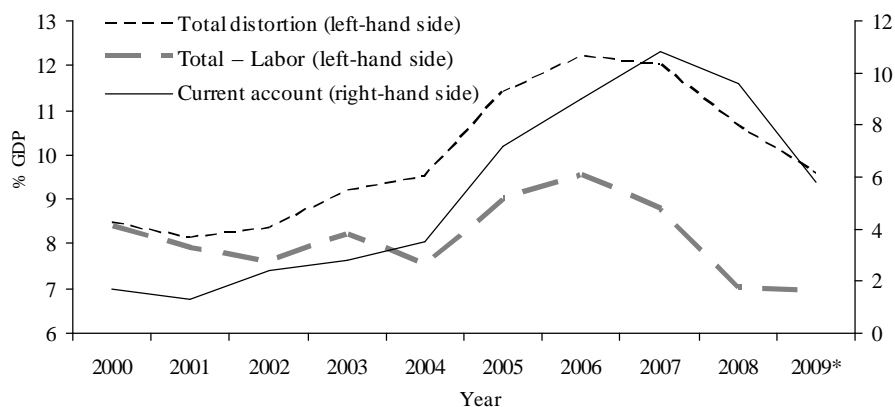
past decade, peaking in 2006.

The estimation results reveal several important findings. First, capital was by far the most important component of total cost distortions. Second, labor cost distortions actually increased in recent years, despite liberalization of the markets. This resulted in faster growth of market wages than migrant workers' wages in recent years. However, this is already changing, as migrant workers' wages have started to rise quickly. Third, distortions to energy costs were very volatile. Finally, total cost distortions already peaked, suggesting that the worst might already be behind us.

These cost distortions are like producer subsidy equivalents. They lower costs of factors, increase profits of production, raise returns to investment and improve the competitiveness of Chinese exports. Such cost distortions enabled China to rise as a global manufacturing center within a very short period. Because production factors are cheap, producers and investors all rushed to China when China joined the WTO, which guaranteed minimum standards of the institutional and market environment.

The distorted factor costs boosted economic growth during the reform period, but they boosted exports and investment even more. The latter explains the growing structural imbalances in China. In fact, the cost distortion measures provide a reasonably good explanation for the recent surge and then moderation of the external imbalances: movements in the current account surpluses (Figure 7). This also implies that, whereas reform of the exchange rate policy is critical for China's sustainable growth, successfully addressing the

Figure 7. Factor Cost Distortions and Current Account Surpluses in China, 2000–2009 (% GDP)



Source: Huang and Tao (2010) and authors' estimation.

Note: Total - Labor is total cost distortions excluding labor cost distortions.

current account imbalance requires a comprehensive policy package (Goldstein and Lardy, 2009; Huang and Tao, 2010).

V. Concluding Remarks

The Chinese economy has achieved extraordinary growth since the start of economic reform. Unfortunately, it has also been accompanied by serious imbalance problems, such as overinvestment, a large current account surplus, inefficient resource use and pollution. For the past 7 years, the government has set the rebalance of economic structure and the transformation of the growth model as top priorities. Most structural problems, however, have worsened despite continuous policy efforts.

The lack of policy impact might be due to the lagged effects. For instance, it takes years to improve consumer confidence. More importantly, however, this lack of impact is a result of the government relying too much on administrative controls. Such measures might be useful in the short term, but they can be inaccurate or unsustainable. The NDRC's control of investment projects is a good example. Sometimes the officials focused on a number of new projects to control the total size of investment, but investors have methods of bypassing the reporting of "new projects."

At other times, the government has adopted the right policies but has not been aggressive enough. The PBOC hiked policy rates and tightened liquidity conditions when the economy showed signs of overheating. However, in most cases, those measures were modest at most. In order to narrow external account surpluses, the government also adjusted export tax rebates and even appreciated the currency, but those managed adjustments were not sufficient to reverse the worsening trends of the imbalance problems.

We argue in this paper 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. Over the past 10 years, the household income share of GDP dropped more than 10 percentage points (Bai and Qian, 2009a,b). These distortions promote growth but support investment and exports even more.

Correction of China's imbalance problems requires a comprehensive package. The government will have to abandon its exclusive emphasis on GDP growth. After all, growth is only the means not the purpose of economic development. Substantial reforms might also be needed to break down the monopoly power of the state-owned enterprises and to redistribute their profits to either the government or households.

A central element of the above comprehensive package, however, has to deal with factor cost distortions. It essentially calls for the completion of market-oriented reforms started more than 30 years ago. Such reforms should eventually leave the determination of factor prices to free markets. It is very likely that factor costs could rise over time. This would slow growth somewhat but should also make growth more balanced and more sustainable.

In a way, the Chinese Government has already started efforts in this direction. From 2009, various departments of the government kicked off resource price reforms, including adjustment of fuel and water prices. The government also began to experiment with HRS reform in 2010. Financial market reform and capital account liberalization should help to reduce distortions to the cost of capital.

Liberalization of factor markets will probably take years to complete. For instance, it will be difficult to fix the land problem, given the government's reservation to privatize land and the concerns for landless farmers in the countryside. What is important, however, is dealing with the root cause immediately, and moving forward steadily. Only by so doing will the government be able to effectively reduce structural imbalances over time.

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