

# China's Consumption Conundrum

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## The Application of the Washington Consensus in the East

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China's adherence to the Beijing Consensus model of economic growth has resulted in 30 years of sustained GDP growth; however, in recent years, GDP growth continues to grow while consumption and household income stagnates. This has caused a myriad of problems for the Chinese. This study finds that in order to solve their consumption problems, the Chinese need to liberalize financial markets while also reducing individual risk associated with education, health, and retirement costs in order to solve their economic problems. In short, the Chinese must abandon their current model of economic growth via domestic investment for the Washington Consensus. Additionally, this paper concludes that GDP growth as a metric for economic development can no longer be used in China's case.

## **Introduction**

Central planning was never supposed to work; however, central planning drives China's economic miracle. China's statist economic policy package, known as the Beijing Consensus, espouses financial market controls, a fixed exchange rate, low provision of public goods, and a bias against private firms. In contrast, the Washington Consensus encourages economic growth via financial liberalization, pro-poor services, privatization, and a liberalized exchange rate. China's adherence to the Beijing Consensus since the economic reforms of 1978 led to an export-oriented economy based on domestic savings and low household consumption. As a result, China's gross domestic product (GDP) has increased by a factor of 13 since then (Lardy 2007). Despite the longevity and speed of this growth, Premier Wen Jiabao branded the Chinese economy as "unsustainable, unbalanced, and uncoordinated," due to its low consumption (Aziz 2007). Realistically, China cannot continue its current growth path without suffering from an international backlash due to growing global trade disparities. On the domestic level, the Beijing Consensus has caused manufacturing inefficiencies and income disparity (Kuijs 2005; Hu 1997). If China seeks to remain an international economic power, it needs to re-direct its mechanism of economic growth from being export and investment based to being consumption driven.

Despite its present problems, the past successes of the Beijing Consensus cannot be ignored; this study will not evaluate whether China could have experienced greater growth under the Washington Consensus. Instead, this study argues that to shift its economy from investment based to consumption based, China must adopt the Washington Consensus. In doing so, this paper reaches two conclusions. First, that in order to curb its consumption problem, China must liberalize, privatize, and reduce individual risk via the provision of public goods. Second, this study finds that GDP inaccurately measures the depth of China's economic development.

## **Consensus and Consumption**

The literature on China's household consumption rate focuses on three topics: why current patterns of consumption hinder economic development, the attempts by the CCP to influence domestic consumption, and relevant theories behind China's consumption rate. In addition to these overarching ideas, this study offers a historical review of the effects of the Beijing Consensus on China's economic development.

### *The Beijing Consensus*

Joshua Cooper Ramos, the coiner of "Beijing Consensus," heralded Chinese economic growth as "not only a model for China, but [it] has begun to remake the whole landscape of international development" (Huang 2011). While Ramos forwent a concrete definition of Beijing Consensus, proponents have since defined the Beijing Consensus as an economic package that eschews market mechanisms in lieu of state-oriented growth. In China, this translated into weak property rights, financial property controls, political bias in capital loans, a fixed exchange rate, and a strong government presence in its economy during its period of economic reforms (Huang 2011). By shunning free-market policies, the Chinese Central Party (CCP) created an economic environment in which private firms falter while China reinforces state-owned enterprises (SOEs). Consequently, China's GDP growth surges forward because of government investment, creating an artificial metric for China's economic development (Huang 2011). Ultimately, while the Beijing Consensus helped China in its export-oriented path, the transition to a consumption-based economy necessitates the free-market policies of the Washington Consensus.

### *Consequences of Low Consumption*

China's savings rate has flushed markets with excessive capital investment. With estimates for China's savings rate ranging from 30 to 50 percent of GDP, further investment will only serve to exaggerate issues of overinvestment and diminishing returns (Zheng 2008). In 2004, excess savings resulted in 90 percent of manufacturing goods in China to be oversupplied; this oversaturation of capital has decreased labor and capital productivity in China (Zheng 2008; Lardy 2006). Twenty years ago, 2 dollars produced 1 dollar of output in China. In recent years, the same output requires 4 dollars of output (Zheng 2008). Despite this input: output ratio being higher than most other nations', the slowing rate of investment in China necessitates an investigation on the sustainability of the Beijing Consensus. Given China's rate of investment, we must not ask how China achieved its GDP growth rate, but why China has not developed faster (Wolf 2005).

Another consequence of the one-sided flow of investment stemming from domestic savings is the growing income inequality between manufacturing rich regions and manufacturing deficient regions in China. Generally, the bias of investment means that inland rural areas receive less developmental aid than their coastal urban counterparts. As capital streams from domestic savings into urban investment, the per capita income in urban areas has become three-times greater than the per capita income in rural areas. This not only presents the problem of inequality, but it results in an underdeveloped agricultural sector and massive migrations of human capital (Kuijss 2006; So 2003; Ngain 2008). Because of the increased opportunities in developed urban production facilities, rural workers have begun to migrate en masse to urban areas; holding urban wages constant, a 10 percent fall in rural wages results in a 0.5 percent

increase in migration rates (Lardy 2006). Beyond the individual, the growing disparity between the urban and rural areas can be generalized to the industrial level. Labor productivity in 2005 estimated that the output for an agricultural worker to be about \$800 while industries such as manufacturing, utilities, and mining had a worker output of \$5,900, nearly seven times as much (Bernanke 2006).

### *Theoretical Framework*

The theoretical framework provided by most scholars follows the prescription of the Washington Consensus while eschewing the Beijing Consensus. Without privatization, liberalization, and public provisions, the Chinese economy cannot correct its domestic under-consumption. These theories are: the supply-side theory, the life-cycle theory, and the financial controls theory.

The supply-side theory posits that China's low consumption rate originates from individuals saving to insure against future risks associated with healthcare, education, and retirement costs. Previously, SOEs accounted for 78 percent of China's industry; however, Deng Xiaoping's economic reforms reduced SOEs to 29 percent by 1996 (Chun 2008). Since then, the CCP further reduced the 2.16 million SOEs in 1996 to 122 thousand by 2004 (Chun 2008). This privatization displaced between 10 million to 25 million workers (Combs 2008). With the elimination of SOEs also comes the elimination of comprehensive social plans that SOEs offered. This results in the previous state-sector employees bearing the full costs of healthcare, education, and retirement. Furthermore, the CCP devotes a negligible amount of money towards the provision of public goods. As a result, individuals save to insure against future risks. According to the supply-side theory, China must allocate more funds towards providing public

provisions in order to increase domestic consumption.

Madigliani's life-cycle theory postulates that the One Child Policy lowers household income which, in turn, diminishes household consumption. With China's improved economy, the current generation of workers earns more income than previous generations. However, the decreasing pool of eligible employees offsets the income increase. As China's working generation ages, the One-Child policy prevents China's labor pool from replenishing itself at a 1:1 ratio, meaning that in time, every Chinese family unit gains more economically dependent members. Thus, as China's population grows, consumption falls due to the life-cycle theory. To correct this growing population disparity, the CCP needs to retract the One-Child Policy.

The weakness and corruption in China's financial sector limits the development of smaller, private firms. In a 2007 study, Aziz concluded that private Chinese firms increase household income more than SOEs due to their higher profit margins and ability to effectively utilize loans (Aziz 2007). Despite these findings, the majority of loans from China's state-owned banks go towards non-profitable SOEs due to political corruption. Consequently, private firms suffer from capital restraints, limiting their development and institutionalization in Chinese markets. These credit restraints create a dichotomy between market wage rate and marginal product of labor, resulting in lowered household income (Aziz 2007).

### *Previous Policy Changes*

In terms of previous policy changes, the CCP has prescribed to a three-pronged method to increase consumption—increased provision of public goods, floating the Renminbi (RMB), and government policies designed to increase household consumption. However, attempts by the CCP to affect consumption rate have been largely ineffective due to the magnitude of change.

Recently, the CCP enacted a rural tax-incentive program to encourage consumption by increasing available income (Lardy 2006). Starting in 2003, agricultural taxes fell from RMB 33.7 billion to RM 12.79 billion by 2005 (Lardy 2006). Additionally, the CCP eliminated grain taxes in two Chinese provinces, reduced grain taxes by three percent in 11 provinces and by one percent in all other provinces (Lardy 2006). Despite these cuts, however, the CCP only reduced income taxes by 1.1 percent of GDP (Lardy 2006). Due to the working wage in China, in order to affect consumption rates, the CCP needs to cut taxes more drastically (Lardy 2006).

In an attempt to create Wen Jiabao's "new socialist countryside," the CCP has increased the provision of public goods in rural areas. Beyond the previously mentioned grain subsidies, the CCP has expanded the rural healthcare system and eliminated fees associated with primary education. All in all, these programs amounted to a sevenfold spending increase in rural areas (Lardy 2006). On a larger scale, healthcare expanded by 25 percent between 2005 and 2006. This increase included healthcare programs for unemployed urban workers and covered workers who do not receive medical insure through their employers (Lardy 2006).

The final policy for the Chinese, the exchange rate, has been reformed the least despite contributing the most to China's export-centric economy. Although in 2005, the CCP appreciated the RMB by 2.1 percent vis-à-vis the US dollar and put it on a floating band of 0.3 percent per day, further appreciation of the RMB has been slow (Lardy 2006). According to the Peterson Institute for International Economics, if China lets its exchange rate rise by 20 to 25 percent over the next two or three years, China's current account surplus would be reduced by \$350 billion while America's current account deficit could be reduced by \$50 billion (Bergsten 2010). However, China's refusal to appreciate the RMB only further entrenches the Chinese economy in its export-oriented path and eliminates the possibility of transitioning to a consumption-based

economy.

### **The Main Argument**

As previously mentioned, this study investigates the effects of the Beijing Consensus's economic policies on China's household consumption rate; furthermore, this study concludes that the CCP needs to adopt the market-oriented policies of the Washington Consensus. Without the provision of social services, the privatization of the financial and industrial sectors and the liberalization of the exchange rate, the CCP will not achieve the economic movement towards a consumption-based economy.

The basis of this study is Qi and Prime's 2009 article, "Market Reforms and Consumption Puzzles in China." This paper, however, contributes to the literature by considering the quantitative data provided by Dr. Prime through the lens of the Beijing and Washington Consensuses. Additionally, this paper uses a qualitative comparison between India and China to determine the salient differences between the two economies.

### *Variable selection*

Given that the quantitative model seeks to explain the low consumption rate of the Chinese in recent years, household consumption within Chinese provinces will act as the dependent variable. To represent the supply-side theory, government consumption was chosen as the dependent variable. Theoretically, government consumption represents the amount of money that the government uses to reduce individual risk. This includes health care, education, and other social services. By reducing individual risks, the government provides a network by which individuals can gain services without having to privately fund them. Thus, household incomes present another facet of government provision of goods. To represent the life-cycle

theory, I chose population growth. Theoretically, when population grows, combined with the idea that the One-Child policy forces incomes to drop, the household consumption rate in China should also suffer.

To represent the effects of a weak financial sector, I chose average worker wage and the number of SOEs present within each province. With the flow of capital favoring larger government firms, the number of SOEs should accurately represent the CCP's privatizing efforts. The more non-performing loans are present within a province, the more likely there are to be a high number of SOE's and less private firms. Additionally, increased numbers of smaller, private, and more profitable firms also positively affects the wage rate of workers. More profitable firms will pay their workers more, so the number of SOEs negatively affects the wage rate, hinting at a weaker financial system. China's attempts to privatize focus on reducing the number of SOEs present within the economy. Thus, for the purposes of this study, I make the assumption that as the number of SOEs decrease, the number of private enterprises must be created in order to compensate for the economic inactivity created by the decreasing number of state firms.

Finally, due to the lack of drastic change in the method by which the CCP manages China's currency, the RMB will not factor into the quantitative model because there would be little or no effect.

### *Data Collection*

Market segmentation due to regional specialization and protectionism makes national level statistics useless. This study employs provincial level data in the quantitative model. Throughout the 1980's and 1990's, entrepreneurial, market-drive rural China developed

separately from state-led urban China. Although the CCP has moved to dictate national market development over provincial independence, regional interests only further fragment domestic markets, causing difficulties in generalizing national behavior (Huang 2008; Young 2000). All quantitative variables will be on the provincial level.

### *Legitimacy of Data*

Thomas Rawski's criticism about the accuracy of China's GDP statistics removes the use of GDP as a statistical measure of economic growth and development in China. According to Rawski, "the implied reduction of 30 percent in unit energy consumption over 3 years seems implausible [compared to the GDP growth], despite the rapid growth of computer manufacture and other activities with low energy consumption. Rapid growth of energy efficiency is not a hallmark of China's economy" (Rawski 2001). Furthermore, in rural and urban areas, the national reports on retail sales increase more rapidly than household incomes. The spending in rural areas suggests that the propensity to spend has surpassed the tendency to save (Rawski 2001). These reports contradict the theory that moderate income gains only strengthen the propensity for people to save. Furthermore, the provincial data used within this study were rejected in 1998 by the National Bureau of Statistics as "cooked local figures" (Xu 1999). With this knowledge, the trends presented in this study are accurate. However, the exact numbers will not be. The analysis will be guided by theoretical work laid down by previous scholars and the findings in this study will need to be tempered with the idea that although provincial data may be numerically inaccurate, the trends within China are still accurate.

## *India*

Given its rapid economic development and its high domestic consumption rate, India provides an informative perspective about China's low consumption rate. Since the 1990's, India's economic growth has mirrored China's in term of population growth and economic development. In some respects, Indian economic growth through economic reforms and industry investment challenges the Chinese economy as Asia's most successful economic power (Becker 2004; Huang 2003). Looking at India's consumption patterns, however, it becomes apparent that countries do not need China's high savings rate for investment-based growth. Through India, a path for increasing Chinese consumption rates becomes possible.

## **Methodology**

This study employs a time-series analysis of quantitative measures for social spending, the life-cycle theory, the strength of financial institutions, amount of disposable income available to households, and China's exchange rate reform along with a case study of India to determine the effects of these variables on domestic consumption.

Based on the previous section, this study elected to use a time-series panel analysis. The time period selected was from the beginning of China's economic revolution, 1978, until 2009, the final year with data available. For panel selection, due to market segmentation and regionalization, this study uses Chinese provincial data. As previously mentioned, the dependent variable in this model is household consumption. The independent variables are: total population, average wage of workers in Yuan, average income in urban areas, average income in rural areas, the number of state-owned enterprises in a provincial economy, and government consumption.

Using literature on the state of the Indian financial, social, and political system, this study

conducts a Most-Similar-System comparison between China and India. In this form of comparative analysis, the variable being measured will be the strength of each nation's financial system due to China and India's similarities in population growth, economic growth, and provision of public goods.

## **Results**

Table 1 reports the results from the multivariate regression. With an adjusted R-squared value of 0.93, most of the variation within the dependent variable, household consumption, is explained by the chosen dependent variables (Table 1).

Average worker wage has a positive relationship with household consumption. Holding all other variables constant, household consumption will rise a unit for every 0.04 units that average worker wages drops (Table 1). With a p-value of 0.00, average worker wage is also a significant variable within the model at the 95 percent confidence interval (Table 1).

Number of SOEs has a negative relationship with household consumption. Holding all other variables constant, household consumption will drop a unit for every 0.05 units that average worker wages drops (Table 1). With a p-value of 0.00, the number of SOEs is also a significant variable within the model at the 95 percent confidence interval (Table 1).

Government consumption has a positive relationship with household consumption. Holding all other variables constant, household consumption will rise a unit for every 1.66 units that rural household income rises (Table 1). With a p-value of 0.00, government consumption is also a significant variable within the model at the 95 percent confidence interval (Table 1).

Rural household income has a positive relationship with household consumption. Holding all other variables constant, household consumption will rise a unit for every 0.12 units

that rural household income rises (Table 1). With a p-value of 0.002, rural household income is also a significant variable within the model at the 95 percent confidence interval (Table 1).

Population growth has a positive relationship with urban household consumption. Holding all other variables constant, household consumption will rise a unit for every 0.21 units that population growth rises (Table 1). With a p-value of 0.00, total population is also a significant variable within the model at the 95 percent confidence interval (Table 1).

Urban household income has a positive relationship with household consumption. Holding all other variables constant, household consumption will rise a unit for every 0.06 units that household income rises (Table 1). With a p-value of 0.007, urban household income is also a significant variable within the model at the 95 percent confidence interval (Table 1).

## **Discussion of Quantitative Model**

Using the provincial data for China provides a robust picture of the indicators of China's consumption; in keeping with the literature, all of the variables tested within this model returned results that would be expected from the theoretical work. This section will review the results and the implications for necessary change in the Chinese economy; following this section will be the qualitative analysis of China's financial system via the lens of India.

### *Supply-side Theory*

Theoretically, the supply-side theory dictates that the movement of government expenditure into people's lives should increase household consumption because it will ease individual risk and increase income. In this model, as government consumption, rural incomes, and urban incomes rose, consumption rates also rose. By the results of this study, supply-side

theory plays a large role in contributing to China's low consumption rate. Of course, this makes economic sense with the privatization of SOEs. As the number of SOEs drastically decreases, the amount of social services provided to the general population also decreases. As a result, incomes drop both due to unemployment and the private provision of necessary goods such as healthcare and education. Therefore, in order to address their low consumption problem in the public goods front, the CCP must drastically increase spending for social services to its citizens.

### *Life-cycle Theory*

Unlike the theory predicts, population growth is positively correlated with household consumption, suggesting that as China's population increases, so does household consumption. There are two possible explanations that cause this phenomenon. First, the generational gap between the pre-One-Child Policy workers and the post-One-Child Policy workers still lags, meaning that the number of older workers still outstrips the number of middle-aged and younger workers. If this is the case, then in a few years, population growth will become negatively correlated with household consumption, meaning that the number of dependents in a family unit will increase while the number of wage-earners in a family unit will also increase. Such a change would cause the life-cycle theory phenomenon as described by Madigliani.

In addition to possible population lag, the validity of the life-cycle theory should also be questioned. In 2007, a model testing the validity of the life-cycle hypothesis against income showed that the life-cycle hypothesis was only significant in 1 of every 4 tests conducted (Horioka 2007). Thus, while Madigliani produced positive results for the life-cycle hypothesis, the actual theory and its validity should be brought into question.

### *Financial Strength*

The effect of a weak financial system in the Chinese economy limits income and wages by not allowing private, more profitable business to flourish (Aziz 2007). Theoretically, as private firms flourish in the Chinese economy, wages also rise. However, with the number of non-performing loans within the Chinese economy, many private firms find themselves credit-restrained, resulting in SOEs developing far beyond their natural limits. In this study, the variables used to test the financial markets—the number of SOEs and average worker wage—return mixed results. While the number of SOEs returns the expected result of being negatively related with household consumption, average wage is also found to have a negative relationship with household consumption, meaning that as average wage goes down, household consumption rises.

The negative relationship between average worker wage and household consumption defy not only expectations, but also economic theory—it simply does not make sense to say that as wage falls, consumption will rise. Based off the theory reviewed within this study, the only plausible explanation for this relationship comes from the relationship between SOEs and household consumption. In areas with more SOEs, average worker wage will be lower than areas predominantly occupied by private industries. However, along with having more SOEs, workers in said region will also have more access to healthcare and other social services. Applying the supply-side theory, this means that consumers in that region will be more likely to consume than in other regions due to the social safety net. Unfortunately, this study concludes that variables selected to measure the strength of China's financial system do not properly represent the strength of China's financial sector.

### *Conclusions about the Quantitative Model*

Although all variables returned significant results in the quantitative model, only the variable chosen to represent the CCP's expansion of China's social safety net—government consumption—should be considered conclusive. Furthermore, this study does not fully consider the effects of the SOEs in the Chinese economy. The waning SOE industry has left a vacuum in Chinese society in terms of health care and unemployment that the government has yet to resolve. Historically, the government's provision of social welfare services has been around 4 percent. Although some rise is seen during the periods of privatization, the upward trend of government spending is not drastic enough to cover the discrepancy. This has translated into about 20 percent of the population bearing the responsibility of providing their own health insurance in 1978 to 60 percent in 2001 providing out-of-pocket health insurance (Lardy 2006). As of 2003, only half of the urban population was covered by basic health insurance and only about one fifth of rural workers were given health insurance, either through work or the government (Lardy 2006). The areas of retirement and unemployment benefits are no better. In 2005, only 14 percent of China's workforce was covered by unemployment insurance and only 17 percent of the entire employed population had pension benefits (Lardy 2006). With these numbers, it becomes apparent that if the Chinese want to eliminate the problem of precautionary savings, they need to increase the amount spent on providing a social safety net that used to be provided by the SOEs. The rapid privatization of SOEs confounds the variables chosen to measure China's financial system. While privatization undoubtedly benefits the Chinese worker's income, the full effect of this cannot be measured until SOEs are largely removed from the sphere of public provisions. Until then, real wages might rise but the purchasing power of Chinese consumers will continue to be constrained.

In relation to this study's thesis—that China needs to adhere to the Washington Consensus instead of the Beijing Consensus—the quantitative model offers strong support for the implementation of pro-poor services in the Chinese economy. However, as for the liberalization of the financial sector, the quantitative model fails to offer a clear solution. Despite this, as will be shown in the next section, China's financial system needs to undergo significant liberalization in order to produce competitive private enterprises.

### **What China Can Learn from India**

In many respects, the Indian growth miracle mirrors and challenges China's economic growth. Since the 1990's, India's economic stagnation during the 1960's and 1970's has transformed into becoming one of the three fastest growing economies in the world (Sen 2009). Despite both countries experiencing high growth from capital investment, the Indian consumption rate remains at 75 percent while China's averages 57 percent. The Indian economy's focus on market-oriented reforms versus China's movement towards more statist policies spurs Indian consumption to remain higher than China's. By reviewing the theories suggested by scholars that contribute to China's low consumption rate, it becomes apparent that if China hopes to increase consumption, the CCP needs to liberalize financial controls and decrease the number of non-performing loans (NPLs).

#### *Indian Healthcare*

The supply-side spending theory points to the amount of individual risk born by the Chinese citizen as the reason behind China's low consumption rate. However, in India, healthcare costs surpass China's costs (Dummer 2008). Despite the Indian burden of infectious

disease higher than China's, only 15 percent of India's total population is provided with health insurance (Bardhan 2008). This low coverage is not compensated by the government; with 20 percent of healthcare services as publicly financed, 40 percent of all hospital goers in India either borrow funds or sell personal assets to finance hospitalization (Duggal 2007). From these statistics, it becomes apparent that individual risk as related to healthcare costs cannot be the reason behind China's low consumption rate.

### *Indian Exchange Rate*

The monetary policy differences between China and India are obvious—China has retained a strong grip on exchange policy and India has allowed its currency to appreciate and depreciate according to market forces. However, India does not necessarily have the advantage in stimulating consumption. Currently, India's economy is supply constrained because demand and investment are pushing prices up beyond an optimal level (Kochar 2007). Even knowing this, the Indian central bank refuses to devalue its currency because the rising rupee benefits Indian consumers (*The Wall Street Journal* 2007). In contrast the Chinese are demand constrained; the massive amount of previous investment through FDI and household savings has pushed consumption up past a point that the domestic market cannot absorb without clear revaluation of the currency.

### *Life Cycle Theory*

The life-cycle theory may explain the reasons behind India's higher consumption rate. The theory would predict that with India's economic and population growth allows for a higher consumption rate than in China. Most importantly, India has not instituted the One-Child Policy

or any form of population control. Additionally, India's population growth currently surpasses China's, meaning that the life-cycle theory cannot be the cause of China's low-consumption.

### *Financing in India versus Financing in China*

The paradox of the Chinese financial system is that China's banks possess sufficient liquidity and low enough interest rates to make loans appealing; however, even with these benefits, the majority of private enterprises are driven by personal financing (Gregory 2001). In the case of China, where large, cash-rich firms have the easiest access to credit, forcing out smaller firms' access to gain credit (Aziz 2007). These constraints reflect the ownership structure of the financial system in banks. The lack of private lenders in China translates into state-owned banks providing credit and capital to state-owned industries (Huang 2006). The economic gains, especially in the realm of employment, for allowing smaller firms to gain access to credit and capital investment would allow for a twofold solution. First, it would allow for an increase in the employment rate; Aziz finds that younger firms tend to have stronger employment growth than older, larger companies (Aziz 2007). The prevalence of non-performing loans in China and thin profit margins for its banking sector demands reformation. Although China's reformation area witnessed a diminished role of the SOEs in the Chinese economy, the lending bias of the state-owned banks to SOEs still hinders the growth of China's private sector. In 1999, the number of bad loans accumulated reached 50 percent of the nation's GDP, effectively cutting off financing to the private sector (Yeung 2009).

Comparatively, Indian economic traditions since its growth period endorse private entrepreneurship, resulting in a more efficient business environment and a more flexible market. With financial systems based in profit and encouraged to pursue profitable loans, only 52 percent

of India's firms reported difficulties attaining capital as opposed to China's 80 percent (World Bank). Additionally, India has not created a political environment that encourages the survival of SOEs or statist policies. As a result, Indian companies have become more competitive on the international stage than Chinese companies. In 2002, the Forbes 200 list of best small companies in the world included 13 Indian firms but only four from the Chinese mainland (Huang 2003).

By allowing market mechanisms to dictate financing policies, the Indian economy allows the growth of household income. As previously mentioned, the number of non-performing loans hinders to the growth of China's more profitable private sector. This limits the growth of employment, resulting in lower household income and, as a result, a lowered consumption rate.

#### *Conclusions about the Qualitative Model*

From this analysis of the differences between Chinese and Indian economies, this study suggests that in order to deepen their economic growth, the Chinese need to reform and strengthen their non-performing loans. Although the life-cycle theory and social spending do detract from consumption rate, India's social spending and its burgeoning populations suggests that the largest problem facing China's economy is the statist banking sector and the amount of NPLs that banks issue for SOEs. In order to align itself to a pro-business attitude, the Chinese financial sector needs to liberalize so as to provide capital to smaller, more profitable firms. Doing so would allow increases in both employment and household incomes which, in turn, would positively affect China's low consumption rate.

In relation to the Washington Consensus model of economic growth, this comparison of financial systems leads to the conclusion that the CCP must abandon the financial controls that bottleneck development of private enterprise. By doing so, the Chinese will experience the

benefits of the Indian economy; more importantly, Chinese firms will become more competitive on the global scale which will lead to reversing the effects of low consumption.

### **Conclusion: Where China Needs to Go**

From the quantitative and qualitative model presented in this study, the three-handed approach used by the CCP until this point presents an initial step for China to rebalance its economic growth, but does not provide the complete answer as to what needs to happen in order for the Chinese to achieve consumption-centric economic growth. Along with finding that increasing public provisions and reducing individual risk, this study finds that the most effective route to balanced economic growth lies with synchronization of the Chinese economy with the Washington Consensus.

The results of the quantitative model used in this paper emphasizes the need to increase household income and, consequently, household consumption via privatization and a reduction of individual risk. By following the Beijing Consensus, the CCP have allowed SOEs and statist economics to weaken the ability of the Chinese economy to privatize and increase consumption. However, with the strong relationship between household consumption with the variables used in this study—population growth, government consumption, rural income, urban income, average worker wage, and the number of state-owned enterprises—suggests that by providing plans that increase social spending, privatization of state-owned industries, and increasing incomes, the Chinese can effectively reverse their current trajectory of economic development. Although certain tax incentive programs have begun to address the issue of household income, further action must be taken in order to make these programs effective. In addition to tax incentive programs, the CCP must encourage its citizenry to consume by reducing the individual risk

associated with the cost of education, healthcare, and retirement; at the very least, the CCP needs to encourage social spending at a rate that offsets the decreasing number of SOEs.

Despite not including the Chinese exchange rate in the quantitative model used in this study, the effect of the RMB cannot be forgotten. Since July 2005, China has limited RMB appreciation to less than 7 percent and has had a constant inflation rate on non-food, non-energy goods at about 1 percent. The control exercised by the CCP over the RMB has drastically contributed to the consumption problem facing the Chinese (Aziz 2007). The length of which monetary and exchange management policies in China have been in effect have achieved the short term goals of attracting foreign direct investment and allowing domestic savings to inform investments. However, at this point, the management of the exchange rate has artificially lengthened the development of China's economy as export-based and has resulted in a demand-constrained economy. The torrid pace of investment has created so much excess capacity that domestic consumers in China are no longer capable of sustaining the amount of buying that will be necessary for China's future growth.

Reformations of China's financial sector and its lending processes to encourage the growth of smaller firms and individual entrepreneurs will also be necessary in building the consumption-based growth that the CCP wants. Two problems currently plague the banking sector. First, loans are not made on a for-profit basis. This is another result of the extensive control that SOEs such as China Telecom still have on basic products. By some estimates, 50 percent of state-owned bank loans go to SOEs (Morrison 2009; Wolf 2005). From these SOEs, less than half return profits meaning that the majority of these loans are not repaid (Mako 2003). To correct this, the Chinese government needs to relinquish its control on banks and capital funds so that the financial sector will loan to smaller and efficient firms (Aziz 2006). The second

problem in the Chinese banking sector is corruption. Often in China, loans are made on the basis of political connections (Morrison 2009). Without these two reforms, the banking system would continue to propagate a system of inefficiency where bank loans are not allocated on the basis of obtaining the highest possible returns (Lardy 1999). Inherent in financial reforms in China would be a reform of the government role in the national economic scale. Although the CCP has already begun to consolidate power from its individual provinces and making economic reform and development a national goal as opposed to a province-specific goal, it also needs to further remove itself from the market realm. The role of state was necessary in developing China to the point that it is at today. However, the continued presence of SOEs, the CCP's involvement in the financial sector, and the exchange rate impedes the organic growth of innovation and movement away from a consumption-centric economy. Furthermore, the widespread corruption in the Chinese market system because of the government's involvement has made it so that in many cases, government connections, not market forces are the main determinants of success for firms. Instead of involving itself in the economic role of the market, the government, as supported by my models, needs to involve itself in the supply-side role of the market and provide methods by which human capital can grow.

With the problems outlined above, it becomes apparent that GDP growth no longer serves as an accurate metric for economic development in China. The use of state resources to spur economic growth in the form of NPLs and the buying of foreign currencies is not a sustainable method to generate GDP growth. Instead, this study finds it necessary for China to liberalize financially in order to encourage organic economic growth vis-à-vis the Washington Consensus to rebalance its economic growth.

For all of the valid criticisms of the path of Chinese growth, China's past growth still counts as a modern economic miracle. However, as shown in this paper, China needs to undergo reforms to transition the economy away from being export driven to being consumption centric. This change will affect the global markets. This news, however, should come as welcome news; as the Chinese rebalance their economic growth to a more sustainable pattern, they will become less of a threat to the stability of the United States and will settle into the role of a sustainable trade partner. As China heads towards a new engine for economic growth, the world will necessarily need to change along with it, but that change, considering the trade imbalances caused by China's aggressive pursuit of exports, will be a welcome change for both the United States and developing countries.

Table 1: Results of Quantitative Model

Household Consumption	Coefficient	Standardized Error	T	P-value	95% Confidence Interval	
Constant	-533.28	121.1095	-4.40	0.00 **	-771.18	295.40
Average Wage	-0.04	0.01	-5.40	0.00 **	-0.06	-0.03
Government consumption	1.66	0.06	26.35	0.00 **	1.53	295.40
Number of SOEs	-0.05	0.01	-4.44	0.00 **	-0.08	1.18
Rural Income	0.12	0.04	3.07	0.002 **	0.04	-0.03
Total Population	0.21	0.03	6.38	0.00 **	0.15	0.20
Urban Income	0.06	0.02	2.72	0.007 **	0.02	0.28
R-Squared	0.93					
N	585					

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