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China”**

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Carmen Mendes

NIPE WP 28/ 2011

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Growth, Consumption and Political Stability in China

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Abstract

A highly successful investment- and export-led growth strategy has positioned China as the second largest economy and as the largest exporter in the world. Households' consumption has played a minor role in its growth strategy, which is reflected in its unique and very high saving rates. In this paper we argue that the low weight of consumption in total expenditure is the result of the pervasiveness of the state in the economy, which aimed at impairing the growth of middle classes and, therefore, at preserving political stability. Nonetheless, an increase in purchasing power and the cultural individualisation of vast portions of the population is leading to an increase in popular mobilisation and social unrest. This indicates that, contrary to common pessimist analyses, prospects for democratization are perhaps stronger than usually presumed.

Keywords: China, growth, savings, financial markets, political stability

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1. Introduction

The rise of China was one of the most important changes in the global economy since the Second World War (Ferguson, 2009). In 2010 China's was the third or the second largest economy in the world, depending on the measure used to evaluate its share in total world output, and it was the world's largest exporter. The astonishing economic performance of China, since the end of the 1970s, was the result of an investment-led strategy, of openness to international trade and of the introduction and development of market institutions.

Although the extraordinary economic performance in the last three decades provides support to the growth-strategy followed by the Chinese State, several authors have questioned the sustainability of this model – see, for example, Blanchard and Giavazzi (2006), Prasad (2009) and Rajan (2010). These critics have been emphasising the need and the benefits of rebalancing China's sources of economic growth, namely, the need to increase the weight of consumption in Gross Domestic Product (GDP) in order to guarantee a stronger growth in the future, gains in job creation, a more equal income distribution, and a reduction in global economic imbalances.

Since 2004 China's leaders have mentioned the need to change the country's growth strategy, namely, the necessity of rebalancing the sources of economic growth (Lardy, 2007). In fact, both the 12th Five-Year Plan and the previous one aimed at increasing the share of consumption in GDP. However, as noticed by Qi and Prime (2009) private consumption expenditures were not positively affected by reforms and Roubini (2011) mentioned that the 12th Plan still relies on investment as the driving force of growth. In fact, an appraisal of the various components of China's GDP growth suggests that despite government rhetoric to expand the domestic market, private consumption is not prioritized.

In this paper, we argue that the low weight of consumption in total expenditure that has resulted from the State's growth strategy, aimed at impairing the growth of middle classes and at preserving political stability. However, given the limits of an ever increasing investment strategy, China will have most likely to increase the weight of consumption in GDP in order to keep the growth pace of the recent decades. Such a change in the growth strategy of China might have a significant impact on political stability. Therefore, this paper discusses the potential effects of an increase in the weight of consumption on political stability through its impact on the development of middle classes.

Section two will contemplate China's rise to great power status. Section three will highlight how this rise is predicated on savings and government allocated investments rather than on household consumption. Section four examines the role of the middle classes and prospects for democratization, with the investment-led economic strategy in mind. Section five concludes.

2. Growth: A rising world superpower

The rise of China as a world superpower is probably the most conspicuous economic and political event of the last two decades. Between 1978 and 2010 the average GDP growth rate of the People's Republic of China (PRC) was approximately 10%, rising at a rate higher than 10% in sixteen years and reaching a maximum of 15.2% in 1984. However, as can be gleaned from the analysis of Figure 1, the GDP growth rate was quite uneven throughout the period. The lowest GDP growth rates were attained in 1989 and 1990, 4.1% and 3.8%, respectively, down from 11.3% in 1988 – those years were marked by political instability, namely, the Tiananmen riots and massacre. In 1991, the growth rate accelerated to 9.2% and in the next two years the GDP growth rate was above 14%. In 1994 the growth rate decelerated and was always below 10% between 1997 and 2002, averaging 8.3% and with a minimum of 7.6% in 1999. From that value the growth rate increased steadily to 13% in 2007. Despite the importance of international trade to the PRC's economy, the impact of the international financial crisis was only to reduce the growth rate to 9% and 8.4% in 2008 and 2009, respectively. The very high GDP growth rates translated into an average increase in per capita GDP growth of more than 7% per annum, in the last two decades.

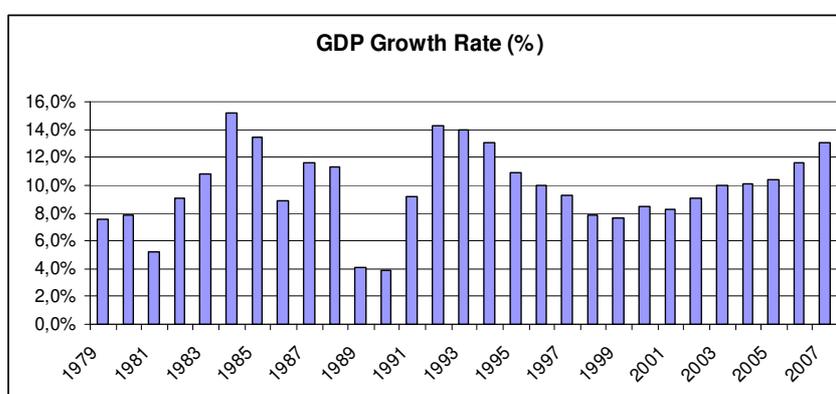


Figure 1. Source: National Bureau of Statistics of China (2010)

The economic performance of the PRC has positioned China as one of the three largest economic areas in the world, alongside the European Union (EU) and United States of America (USA). Economic growth is the basis for the emergence of the PRC as an international great power. Between 1980 and 2008 its share of total world output, as defined in Angus Maddison’s database, increased from 5% to 17%, approximately the same share of Western Europe and close to the 20% share of the USA economy, which during the 1990s became the most important economic area in the world – see Figure 2.¹ According to several forecasts, China will become in the near future the largest economy in the world. For example, according to the forecast of the Nobel Prize in Economics Robert Fogel, by 2040, China will produce 40% of the world GDP whereas USA and the European Union will account for 14% and 5% of the total world output, respectively (Fogel, 2010). Albert Keidel from Carnegie Endowment for International Peace predicts that China’s economic size will equal the USA by 2035 and double it by 2050 (Keidel, 2008). All these economic growth projections point to the global economic preeminence of China in a very near future.

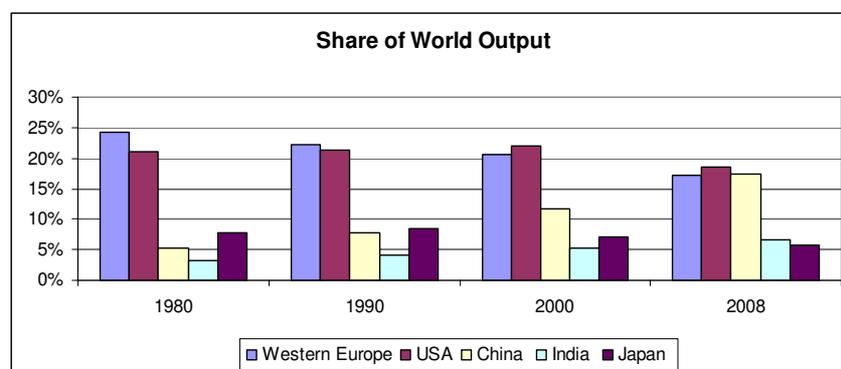


Figure 2. Source: Maddison (2010)

¹ Using nominal exchange rates the share of China in world output would be approximately 11% and it would be the third largest economy far behind the European Union and the United States of America. However, as discussed below, there is evidence that the Renminbi has been significantly undervalued, at least in the last two decades, thus it is favourable to use adjusted measures of exchange rates such as Purchasing Power Parities.

The international financial crisis seems to have reinforced the role of China in global politics, that is, as a world superpower.² In fact, in the G20 meetings that followed the financial crisis, looking for cooperative solutions in the regulation of financial markets and measures to accelerate the economic recovery, China and the USA have led works and discussions in many circumstances giving rise to the term G2. But, even though China is becoming progressively assertive in the international sphere, it still attempts, in a Deng Xiaoping fashion, to downplay its real capabilities, and does not feel comfortable with the G2, as it does not intend to publicly acknowledge parity of power with the USA.

The Chinese leadership, and scholarly community (Xia, 2001), seems to acknowledge that their country's rise to great power status depends on the maintenance of economic growth and on the continuing amplification of interdependence. After an official trip to the USA in 2002, Zheng Bijian, a senior official and director of the Chinese Communist Party (CCP)-affiliated China Reform Forum, began to propagate the notion of China's "peaceful rise". He realised that perceptions in the West on China's emergence were polarized, at one extreme, around the idea that the global power transition represents a major threat to USA security, and at the other, around the expectation that China will inevitably collapse due to internal socio-economic contradictions.

Both hypotheses, of threat and collapse, work against a stable ascension. Therefore "peaceful rise" was proposed as a publicity slogan to assuage international fears and attempt to convince foreign audiences that economic development is the prime national interest, and will supplant policies that hinder the construction of a stable foreign and domestic environment conducive to growth. The domestic dimension of "peaceful rise" involves rebalancing the country's growth model. In 2003, during a speech at Harvard University, Wen Jiabao (quoted in Glaser & Medeiros, 2007:298) claimed that expanding the domestic market and converting huge citizen savings into investments were essential aspects of China's peaceful rise. Although the term 'rise' was subsequently replaced by 'development', in an attempt to erase the threatening connotations of rise, the core policy priorities underlying the slogan remain. And so seems to remain the mitigated role of the domestic market in China's growth strategy, which we discuss in the next section.

² The economic performance of China during the international financial crisis seems to corroborate the decoupling hypothesis, according to which emerging economies are less sensitive to the business cycle of developed countries, in particular to the US business cycle (Kose et al., 2008).

3. A successful and unique growth strategy: investment not consumption

In Figure 3, we present data on the contributions to real GDP growth of private consumption, investment, government consumption and net exports in the 1980s, in the 1990s and in the period 2001-2005. The most striking feature of these data is the steady increase in the contribution of investment expenditures to real GDP growth, increasing from approximately 25% in the 1980s to more than 50% in the period 2001-2005. In fact, investment in fixed capital formation, that is, new factories, infrastructures and housing, has been the main driver of economic growth since the end of the 1980s. This role of investment was reinforced during the international financial crisis in order to compensate for the decrease in exports.

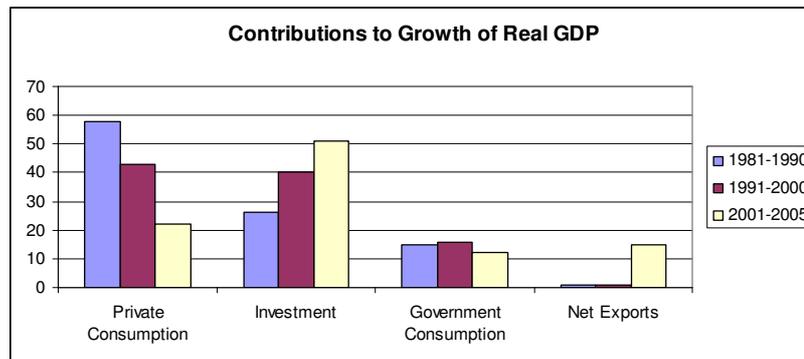


Figure 3. Source: McKinsey Global Institute (2006)

Although a strong capital accumulation or an investment-led growth strategy has characterized other East Asian countries, such as Japan, Korea and Malaysia, similar values for the investment rate (the ratio between investment and GDP) have occurred for very short periods. The very high investment rates of China make it singular in the history of economic growth: throughout the period 1978-2008 the average investment rate was approximately 33%, rising to more than 40% in the period 2004-2008 and reaching 43% in 2006 – see Figure 4.

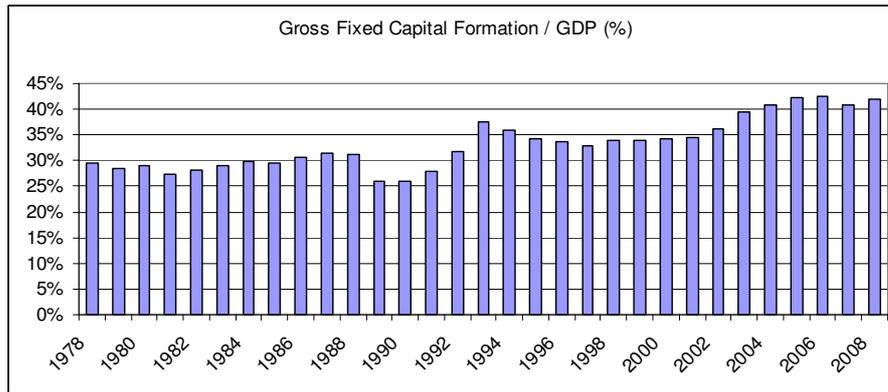


Figure 4. Source: National Bureau of Statistics of China (2010)

The expansion of the domestic market, aiming at rebalancing the country's long-term growth model, is allegedly one of the key objectives of ongoing reforms and of the 11th and 12th Five-Year Plans. However, the plummeting net contribution of private consumption to real GDP and the prioritization of fixed capital formation over household consumption can be taken as evidence that so far the government has not abandoned its investment- and export-led strategy.

The high investment rates have been financed by very high domestic savings by households, firms and the Government. In Figure 5 we show net national savings as a percentage of gross national income (GNI) for China, India, USA and Germany, since the beginning of the 1980s. Domestic savings in China have been very high when compared to developed countries like the USA (which is known for its very low saving rates) or Germany, but also when compared to countries of similar development such as India. Additionally, the saving rate has increased from 21% in 1982 to 44% in 2008. The increase in the saving rate was very strong since 2000, when it was 27%.

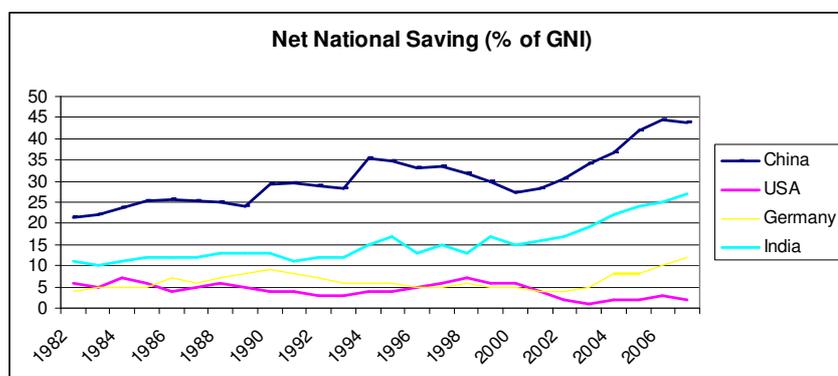


Figure 5. Source: World Bank (2010)

Several authors have been investigating the factors behind the very high saving rates in China's economy. According to Modigliani and Cao (2004) the absence of a national public pension system is an important determinant of the high saving rates. Chamon and Prasad (2008) analyze the factors behind the rising saving rates of urban households and conclude that precautionary motives in face of rising health care and education expenditures are the main explanation (see also Qi and Prime, 2009). These authors also suggest that the transition to a market economy has increased uncertainty, which might have had a positive effect on saving. Finally, Chamon and Prasad (2008) emphasise the role of the underdevelopment of financial markets and the limits it imposes on households borrowing, namely to buy durable goods and housing. Therefore, to circumvent borrowing constraints households have to save. These analyses of the causes of high saving rates in China suggest that a shift in its rising trend requires an increase in social expenditures by the government, namely on health care, education and pensions, and more developed and deeper financial markets.

The other side of the saving rates equation is private consumption behaviour. Despite advances toward a market economy and the recent declarations of China's leaders defending on several occasions the strengthening of domestic consumption (e.g. Lardy, 2007), the weight of consumption in GDP has steadily decreased since the beginning of the 1980s, when it represented approximately 55% of total expenditure. In the period 2001-2005 it averaged only slightly more than 40%. According to data from the International Monetary Fund (IMF), the rate continues to drop. In 2008 consumption accounted for only 37%. This share of consumption in GDP is very low when compared to developed countries and also when compared to countries of similar development levels as India. For example, in 2005, household consumption in USA, United Kingdom and Japan accounted for 70, 60 and 57 percent of GDP, respectively. In India the weight of household consumption in GDP, in 2005, was 61 percent, even though its GDP per capita was less than half of China's.

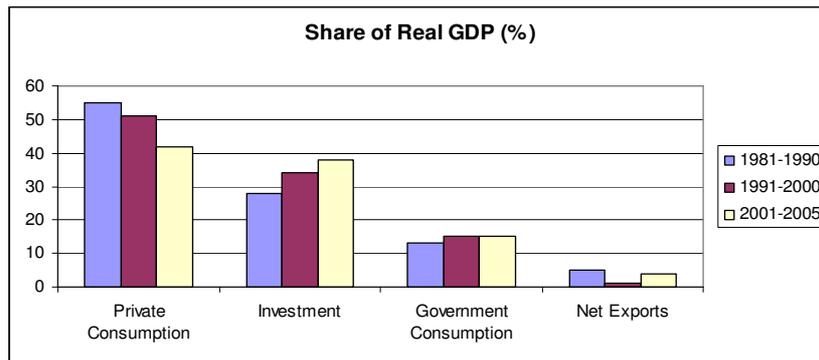


Figure 6. Source: McKinsey Global Institute (2006)

Figure 6 shows that government consumption as a share of GDP has been fairly stable and is also very low, compared to other major economies in the world, averaging around 14 percent of GDP throughout the period. Between 2001 and 2005, the growth of net exports of goods and services has also been a major source of economic growth, increasing from 1.7% of GDP in 2004 to more than 4.6% of GDP in 2005. In 2006, net exports represented 6.7% of GDP and approximately a fifth of China's growth (Lardy, 2007). While investments and trade blossom, in relative terms consumption dwindles.

All these measures would contribute to the development of middle classes. Although they are becoming more populous and richer, when the pace of overall growth of the Chinese economy is taken into consideration, it seems middle classes have not been the primary beneficiaries of economic reforms. In fact, it seems that the government's growth strategy has been indirectly constraining the power of the middle classes. The 1989 and 1990 slumps in GDP growth revealed to senior decision makers the great threat that political stability represents to China's rise. Given the role middle classes play in provoking unrest and demanding regime change, for example in Hong Kong, China's investment-led growth strategy might also be understood as a mechanism to reduce middle class consumption and power, and to maintain political stability.

4. Middle classes and the quest for democracy

According to a Euromonitor report (Hodgson, 2007) widely publicised by Chinese media, in 2007 China's middle class included 80 million people. But this sum is estimated to reach 700 million, or half of China's forecasted population, by 2020. Even if the estimation turns out not to be correct – among other factors, that estimation will depend on the government's decision to effectively rebalance the country's long-term growth model -, China's intermediary social

stratum is bound to widen. This has implications for political stability, but scholars do not agree on what those may be. Conventionally, two widely encompassing approaches to the correlation between middle class growth and political stability prevail (Tomba, 2009a:2). On the one hand, optimists believe the intrinsic and structural characteristics of middle classes lead them to value positively political choice and democracy. On the other, pessimists argue that, on the contrary, middle classes bring stability and prevent regime change. In any case, it is necessary to ask who the middle classes are.

Yang (2010) contends that the Chinese middle class does not yet have a cohesive identity or class culture. There are internal divisions and three main groups can be identified. The new middle class is comprised of party officials, entrepreneurs and senior-level bureaucrats and technocrats. The traditionally self-employed form the old middle class. The marginal middle class includes the majority of urbanites that have recently experienced upward social mobility and work in the commercial or service sectors. Yang stresses how the middle class as a whole tends to have high expectations in terms of social justice and a fairly positive attitude to democracy. However, it is not possible to make this attribution to all segments of the middle class.

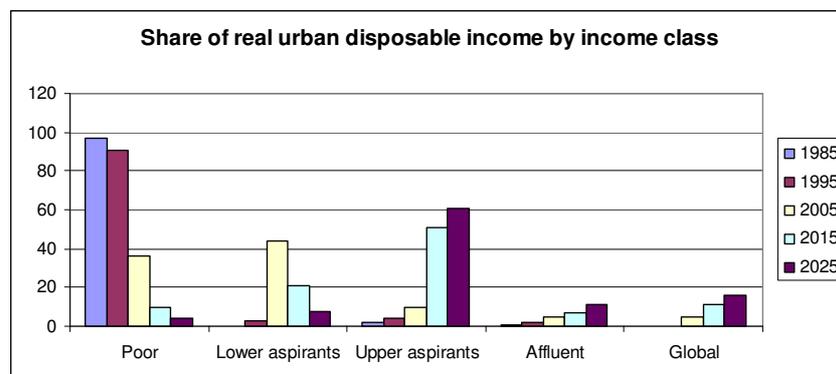


Figure 7. Source: McKinsey³ Global Institute (2006)

Many authors (for example, Wright, 2010) stress the fact that most sectors of society in China have benefited from the country's massive creation of wealth. From this viewpoint, the better-

³ The McKinsey Global Institute (2006) definition of economic classes in China groups urban households into five annual income ranges: Poor, less than 25 000 renminbi; Lower aspirants, 25 000 to 40 000 renminbi; Upper aspirants, 40 000 to 100 000; Affluent, 100 000 to 200 000; and Global, greater than 200 000 renminbi. Middle class refers to lower and upper aspirants, that is, households earning between 25 000 and 100 000 renminbi per year (this is equivalent to a household annual income between \$13 500 and \$53 900, using purchasing power parity exchange rates).

off are happy with what they have gained and the middle classes are waiting for their 'slice of the cake'. Governments can legitimize their rule and maintain political stability by means of performance or by mass persuasion, and usually a combination of both (Brady, 2009, 434). To put it in Bakken's terms (quoted in Tomba, 2009b), the legitimacy of the post-Mao Communist Party lies in its simultaneous effort to develop material civilization and spiritual civilization, or social control. China's economic performance is a major source of legitimacy and attraction both domestically and internationally. The government realizes this and strives to maintain growth. In fact the ancient 'mandate of heaven' doctrine, which has been invoked for centuries in China to correlate legitimacy with performance (Glanville, 2010), has recently appeared in various forms in official governmental discourse.

However, wealth has been unequally distributed. Figure 7 shows that disposable income is still concentrated in the hands of the lower middle class and the poor, but this is shifting rapidly as the aspiring middle classes hoard wealth changing their class status into affluent. They have clear economic incentives to demand change. Despite a comparatively high level of political stability, social unrest is on the high. The number of "public order disturbances" increased by nearly 50% between 2003 and 2005, from 58,000 occurrences to 87,000 (Lum, 2006). Although it is hard to infer what these numbers actually mean, due to methodological uncertainties in Chinese statistics-making, they do highlight a significant degree of social tension in China. The government is very cautious of any potential triggers of social unrest and public mobilization, and has blocked access to information on the internet regarding the Jasmine revolution and other revolts in Maghreb. After anonymous calls for mass protest were made on networking sites and social media, security forces were amassed in locations of suspected public gatherings in various cities (New York Times, February 20th 2011).

Scholars of China's social structure are offering mixed pictures. Li (2010) argues consumption of real estate is a major sociological phenomenon in China. The current middle-class fever for home ownership in gated communities, or "private paradises", on the one hand results in a trend towards privatized living and collective or political apathy. On the other hand, it has triggered public activism against encroaching developers. Kuah-Pearce & Guiheux (2009) emphasize that social claims are becoming increasingly institutionalized and political mobilization gradually more organized. However, the institutionalized activities of lawyers and Non-Governmental Organizations (NGOs) can both challenge the current regime and offer means for the middle classes to vent off frustration, increasing stability.

According to Tomba (2009b), the government intends to create subjects that are independent enough to choose what to consume but responsible enough not to contest the political status quo. But, private consumption figures indicate that the government does not want the domestic market to expand too much, most probably because it recognizes the threat to stability inherent in middle classes. There have been numerous mass demonstrations with democratic strands in Hong Kong on an almost annual basis. For example, on July the 1st 2003, half a million people gathered to protest against an anti-subversion law. The democratic movement in Hong Kong is backed primarily by the middle classes (Lin, 2006:170), giving the central government in Beijing one more reason to be worried about growing middle class power. Businessmen are also present in the Hong Kong democratic movement. Over on the mainland the entrepreneurial class is assuming increasingly important roles in the CCP, although none in the top leadership.

Hong Kong has a very significant role in the mainland as a beacon of exemplary middle class consumer behavior. The nouveaux riches often cross the border to spend their newly found wealth in Hong Kong shopping outlets. While in an intensely transnational environment, new social values and political ideas are encountered. Furthermore, values related to consumer culture are often closely related to political values. If the social structures found in Hong Kong are gradually exported to China, increased consumer choice may translate into an urge for greater political choice. The pace at which these changes will take place will depend on China's government economic policy options, namely on its resolve to rebalance its growth model towards households consumption and social expenditures.

5. Conclusion

The State has channeled households' savings to finance public investments in infrastructures and private investment, hindering private consumption and the development of middle classes, through the control of the bank-based financial system. This growth strategy makes China's economy closer to a centralized and planned economy rather than to a decentralized economy. In China's economy, high savings signify a constraint on consumer choice, with disposable income being transmuted into fixed capital investment instead of being spent on household consumption. Ultimately, wealth created by workers is allocated according to state priorities, in detriment of potential consumer power and choice. In this paper, we argue that although the astonishing performance of the Chinese economy provides support to the growth strategy followed so far, it may also be explained by the goal of political stability.

In fact, once the middle classes have greater access to goods, vastly increased consumer choice can lay the motivational foundations for people to want greater political choice as well. This process affects each individual consumer, gradually, but could eventually trigger an orchestrated middle class claim for regime change and democratization.

The early 2011 revolutions in North Africa demonstrated to the world that economic growth is not enough to curb social unrest. On the contrary, greater wealth, especially when it is unequally distributed, can strengthen dissidence. Although the central government in Beijing has swiftly quelled any reverberations of the African uprisings on Chinese soil, the potential for similar movements is realistic and increases in probability with the rise of the middle classes. Arguments vary as to whether the middle classes and their private consumption foster stability or unrest, but one incontrovertible fact is that Beijing is willing to spend as much as deemed necessary to maintain social equilibrium. During the 2011 plenary session of the National People's Congress (NPC) the public administration category of *wei-wen*, which encompasses maintenance of law and order, civil surveillance and crackdown on dissent, was highlighted like few times before (Lam, 2011). For the first time, the *wei-wen* budget exceeded the official military budget, reaching a total of \$95 billion dollar, a 13.8% increase in relation to 2010.

The preoccupation with quelling civil unrest is dominating the 2011-2015 Five Year Plan. There is little evidence that political reforms and the adoption of Western style freedom and democracy narratives will gain any significant weight in the near future. The swift and powerful People's Armed Police reaction to calls for protests and mass agglomeration, stimulated by the Jasmin Revolution in North Africa, demonstrates China's obsession with maintaining 'social harmony' and conformity at all costs. This may hinder the recently announced objective in its Five-Year Plan of increasing the weight of consumption on total expenditure. Therefore, it seems that the Chinese authorities may face a dilemma between high growth rates and political stability: to attain the first objective they may be obliged to rebalance the growth model towards an increase in consumption which, in turn, will favor the development of middle classes, which may give rise to political instability.

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