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Savings boom raises questions about growth and decoupling

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Published: January 6 2010 02:00 | Last updated: January 6 2010 02:00

In 2008 stock markets in the developing world were savaged. Last year they saw record inflows that look set to continue. In part, the reversal in sentiment reflects the fact that while some emerging market economies were severely hit by the economic crisis, the overall picture was less bad than expected. Yet the renewed enthusiasm for emerging markets in the second half of 2009 was also spurred by a return of the questionable decoupling theory. This asserts that emerging markets have freed themselves from export dependence on developed world demand and can safely forget about global imbalances.

The euphoria is not entirely nonsensical, at least in the short term. There is a widespread perception that China, with a trade surplus of nearly seven per cent of gross domestic product in 2008, is heavily dependent on export-led growth, as are many other emerging markets. Yet as Eswar Prasad points out in the latest issue of *Finance and Development* , the direct contribution of net exports to Chinese GDP growth amounted to only 1.1 percentage points a year over 2000-08, or just a 10th of overall GDP growth, because the country is also a huge importer.

Over the same period, the share of investment in GDP rose by about eight percentage points, providing the main driver of growth, while private consumption declined dramatically from 46 per cent to 35 per cent. The composition of China's GDP helps explain why it managed to expand at a rapid, if lower, rate last year while the global economy was shrinking. Likewise why many Asian exporters quickly bounced back, since China became a more important market for them than the US.

The question decouplers have to confront, though, is whether a Chinese growth model based on excess savings and huge investment is sustainable, since these reflect big distortions in the economy. While the Chinese, who lack a proper social safety net and developed financial markets, are naturally thrifty, it is often overlooked that the corporate sector has been as important a driver of savings growth over the past decade.

With an underdeveloped financial system, companies depend more on retained profit, or savings, to finance investment, while state-owned companies were not until recently required to pay dividends. Since real interest rates in the banking system are negative, companies understandably like to recycle retained profits into new investment, which also enjoys state subsidies. The outcome is that growth is increasingly reliant on companies investing in sub-optimal projects.

This is not a game that can go on for ever. So unless China finds a way of promoting private consumption growth, it will become more dependent on exports to countries in the developed world that are trying to shrink their trade deficits, as will Asian exporters that have hitherto milked the Chinese investment boom. Decoupling may thus prove temporary, while the problem of global imbalances will continue to nag away as trade friction mounts.

The silver lining, if there is one, is that China's interest (and that of much of the rest of Asia) probably lies in addressing its own domestic imbalances by reversing the decline in private consumption. As Mr Prasad points out, its investment-oriented growth model has resulted in limited employment growth of barely one per cent a year in a country that has been growing at more than 10 per cent.

For an economy with such a vast labour force and serious underemployment, the implications for economic and social stability must worry policymakers. Increasingly profitless growth in the corporate sector will ultimately rebound on the public finances.

A more flexible exchange rate and a retreat from excessive reserve accumulation would obviously help rebalance the economy. So, too, would a financial system operating on something closer to market principles. For one of the ironies of the current crisis is that while many are preoccupied by the lack of social utility in sophisticated Western banking, the damage inflicted on the Chinese economy and the Chinese people by financial underdevelopment is considerable.

John Plender is an FT columnist