Expanding Domestic Aggregate Demand

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Abstract

The real question for Chinese economic growth is whether there will be sufficient domestic aggregate demand. China is a surplus economy, with not only surplus labour, but also surplus capital, as well as surplus productive capacity. As long as there is demand, there will be supply, so that the level of its GDP is basically determined by the level of its aggregate demand. Domestic aggregate demand may be increased through an increase in household consumption; and household consumption may be increased through an increase in household wealth, brought about by a systemwide expectation of accelerated wage progression. Other sources of increases in domestic aggregate demand include public goods consumption, infrastructural investments, promotion of long-term rental housing and the enforcement of anti-monopoly and anti-trust laws to make markets more open and competitive.

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1. Introduction

The real question for Chinese economic growth is whether there will be sufficient domestic aggregate demand in both the near term and the long term. China is a surplus economy, with not only surplus labour, but also surplus capital, as well as surplus productive capacity. As long as there is demand, there will be supply, so that the level of its GDP is basically determined by the level of its aggregate demand. Moreover, Chinese economic growth today is no longer driven by increases in net exports; but mostly by increases in domestic aggregate demand--household consumption, public goods consumption, and gross domestic fixed investment--with gross fixed investment being the most important source.

2. Increasing Household Consumption

The level of household consumption depends on the current household income and household wealth. Chinese household consumption as a percentage of GDP, currently less than 40%, is low by international standards. It is the combined effect of a low share of labour in GDP (61.5% in 2020) and a high marginal propensity to save on the part of households. Household consumption can be raised by raising either household income or household wealth, or both. But raising current household income requires raising current salaries and wages across the board, which may not be easy to achieve in the near term.

However, it is actually possible to raise current household wealth without raising current household income, that is, without raising current salaries and wages. Household wealth consists of two components: tangible wealth, the value of all assets owned less liabilities, and intangible wealth, principally human capital, the discounted present value of future net after-tax earnings[2]. If a worker is promised a previously unexpected permanent raise five years from now, his wealth rises immediately, through the increase in his discounted present value of future earnings, even though his current income remains the same.

Thus, current household consumption can be increased by the adoption of a plan to accelerate the wage adjustments of workers in, say, five years' time, relative to the current expectations. For example, if under the current wage structure, a worker starting to work at

[2] Thus, a permanent decline in the rate of interest will also increase the value of human capital and hence household wealth.

age 25 at a monthly salary of 10,000 Yuan, will receive raises of 5,000 Yuan a month on the basis of promotions and seniority every five years, he will end up with a salary of 40,000 Yuan a month before his retirement at age 60[3]. The proposed change is to accelerate the wage progression but keeping the starting and terminal salaries the same by making each raise, say, 7,500 Yuan instead of 5,000 Yuan, so that by age 45, he will be receiving the top terminal salary of 40,000 Yuan, which will remain constant until retirement at 60. It is clear that the value of his human capital, and hence his wealth, will increase immediately upon adoption of this proposal, but his current household income will remain the same for the first five years[4]. Since the Government itself is a major employer, both directly, and indirectly through its administrative units and state-owned enterprises, its adoption of such a proposal can affect the compensation practices of the private sector through competition on the labour market.

The accelerated wage progression can be justified on the grounds that the current cohorts of workers are much better educated and hence more productive. Note also that this proposal does not change either the starting wage or the terminal wage. It only changes the time it takes to go from the starting wage to the terminal wage. Moreover, this proposal has the additional benefit of providing young families with more resources during their child-rearing years so that they may be more willing to have a larger family. Such a change in the wage structure will also eventually increase the share of labour in GDP.

A question may arise as to how these wage and salary increases can be financed. It is important to note that under the proposal there is no immediate raise, only a promise of a bigger raise in five years' time. However, the increase in household wealth resulting from the proposed change of the wage structure should increase household consumption and hence GDP immediately and the government will be the net beneficiary of the increases in tax revenues during the first five years. In other words, the proposal can be largely self-financing[5]. An additional source of revenue that can be tapped is the cash dividends paid by the publicly listed state-owned enterprises to their non-listed parents. The functions of these parents have declined over the years as previously laid-off workers reach their retirement ages. A substantial

[3] His salaries at ages 30, 35, 40, 45, 50 and 55 will be respectively 15,000 Yuan, 20,000 Yuan, 25,000 Yuan, 30,000 Yuan, 35,000 Yuan, and 40,000 Yuan.

[4] Once this plan is put in place, the accelerated wage progression will also be applicable to existing workers, not just new workers.

[5] An additional source of revenue that can be tapped is the cash dividends paid by the publicly listed state-owned enterprises to their non-listed parents. The functions of these parents have declined over the years as previously laid-off workers reach their retirement ages. A substantial proportion of these cash dividends can probably be remitted to the State Treasury without causing any major problems.

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3. Increasing Public Goods Consumption

As China's per capita GDP increases and the Chinese Government shifts its focus from the quantity to the quality of economic growth, the demands for public goods such as education, health care, elderly care, de-carbonisation[6], environmental preservation, protection and restoration, public safety, and poverty alleviation, will also rise. The costs of the provision of these public goods also consist of two components: investment in the underlying infrastructure, and the on-going current operating and maintenance expenses. The discussion of the capital expenditures will be deferred to the investment section. The principal challenge to increasing public goods consumption is providing a tax base for provincial and local governments that can generate the revenue to finance these continuing but necessary current expenditures. A prime candidate is a local property tax the revenue from which can be used to pay for local public goods such as education, health care, public safety, as well as blue skies, green hills and clear water.

4. Increasing Gross Fixed Investment

Investment demand, especially the investment demand of the private sector, is driven mostly by expectations about the future. And expectations, if credible and widely held, can be self-fulfilling. However, because of the COVID-19 epidemic, which began in early 2020, public expectations are currently at a relatively low point. Unfortunately, monetary policy alone, for example, lowering the rate of interest, will not be enough; because, as is well known, one can pull on a string, but one cannot push on a string. The Chinese Government should exercise leadership and take concrete actions to change public expectations. There will have to be efforts to increase aggregate demand more directly through increasing gross domestic fixed investment and to transform public expectations.

The two major components of Chinese gross domestic fixed investment are infrastructural and residential real estate investments. Recently, residential real estate investments have been impacted by the failure or insolvency of some of the real estate developers. However, the demand for residential real estate investments can be supported by not only owner-occupied housing but also by rental housing. The Chinese Government can

[6] Peaking carbon emission by 2030 and achieving carbon neutrality by 2060.

promote long-term rental housing under corporate or other institutional ownership as an alternative to owner-occupied housing, thus maintaining the demands for the downstream construction and building material sectors. The ultimate total residential housing demand is of course the same, but there can be a different equilibrium between long-term renting and owning [7]. Recently, Minister NI Hong of the Ministry of Housing and Urban-Rural Development said that the construction of long-term rental housing units should be increased.

Increases in infrastructural investments can also increase the demands of the construction and building materials sectors. They include not only the traditional infrastructural investments in communication, transportation and power, but also the public goods infrastructure such as schools, universities, hospitals[8], and elderly care homes, especially in the less developed parts of China.

Infrastructural investments are basically capital expenditures that can be financed with bonds issued by either the Central Government or the provincial and local governments, or on a project basis. An alternative is for the central bank to purchase provincial and local government bonds for the explicit and sole purpose of constructing certain infrastructure for specific local public goods that cannot be diverted to any other purpose.

5. Making the Markets More Competitive

Chinese government leaders from President XI Jinping and down have repeatedly emphasised that China is and will remain a market economy. In order that the economy can benefit fully from a market system, it must be kept competitive, with free entry and exit in every industry and sector. It is well known that a monopoly produces a smaller quantity of output and charges a higher price than a competitive market with multiple producers. Thus, making the market more competitive through the regulation of monopolies and the use of anti-trust laws can actually increase total output (aggregate demand) and lower the price (inflation). They should not be viewed as policies targeting against private enterprises per se. Even authorities in the capitalist economies of the European Union and the U.S. have also been going after their monopolies and quasi-monopolies to improve consumer welfare.

In addition, making a natural monopoly serve as a truly public utility can also make possible new economic activities that are otherwise impossible. For example, with the formation of Pipe-China from the consolidation of the pipelines of PetroChina, Sinopec, and

[7] For example, in some German cities, for example, up to 40 percent of the residents may be renters.
[8] In particular, it is only prudent to be well prepared for the next epidemic.

CNOOC, the three state-owned Chinese oil companies, it is now possible for independent oil producers and refineries to emerge and prosper, using the newly public pipelines, which can result in increases in both investment and aggregate demand. Finally, the elimination of explicit or implicit domestic trade barriers set up by local governments to protect local monopolies can also increase the local aggregate demands.

6. The Major Uncertainties

However, even as the COVID-19 epidemic has become "normalised", the Chinese economy is still faced with significant uncertainties. A first uncertainty is the possibility of a global economic recession, affecting Europe and North America. Fortunately, the Chinese economy is no longer dependent on exports—with the main driver of its growth being domestic demand. Moreover, as a huge continental economy like the U.S., the domestic Chinese economy is largely unaffected by external disturbances. Thus, while the Chinese rates of growth of exports and imports fluctuate like other East Asian economies, the rate of growth of its real GDP has remained and will remain relatively stable.

A second uncertainty is the China-U.S. strategic competition, which is likely to be the new normal for the coming decade, with continuing "wars" in trade, investment, and technology. Some de-coupling of the Chinese and U.S. economies is therefore inevitable under these circumstances, but the economic impacts on both economies should be relatively marginal. The continuing U.S. tariffs on imports from China have had only a small effect on the Chinese economy. Export controls on U.S. high-technology hardware and software can indeed slow down some sectors in the Chinese economy to a certain extent, but not really essential Chinese projects critical for its national security, such as the manufacturing of super-computers, for which cost per se is not an important consideration[9]. Moreover, the China-U.S. strategic competition is not likely to result in a hot war between China and the U.S. because the resulting casualties and losses will be unthinkably enormous on both sides. There will be no winners, only losers. I remain optimistic that rationality will prevail and there will not be a hot war, just as the former Soviet Union and the U.S. managed to avoid a war in the last Century despite their intense rivalry.

Finally, there are the geopolitical uncertainties posed by the Russia-Ukraine conflict and the Taiwan Straits. There is the possibility that the Chinese economy may be sanctioned

[9] Chinese super-computers today can be built entirely with domestically produced components.

by a U.S.-led group of Western countries for one reason or another. Again, the hope is that peace will prevail.

Because of all of these uncertainties, the 2023 target growth rate for the Chinese economy has been set by the Chinese Government at 5%[10], which is eminently achievable unless a war breaks out.

7. Concluding Remarks

Despite the many uncertainties, short of a hot war, the Chinese target rate of growth of 5% for 2023 should be not only achievable, but also exceeded. My personal forecast for 2023, made before the Chinese Government announced its target, was 6%, reflecting the fact that I am and have always been an optimist. The recovery from the COVID-19 epidemic and the restoration of the interrupted supply chains should help in the near term. The long-term outlook remains very positive--my personal prediction is an average annual rate of growth of between 5.5% and 6% over the next decade. Domestic aggregate demand will recover and grow so that the entire potential output of the Chinese economy can be realised and fully utilised.

[10] The weighted average of the target economic growth rates of all the Chinese provinces, municipalities and autonomous regions for 2023 is 5.64%.