Chinese Economic Growth: Past, Present and Future

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A Preview

◆ The Chinese Economy Today
◆ Near-Term Outlook
◆ The Hu-Wen Strategy of Economic Development
◆ Long-Term Prospects
◆ Concluding Remarks
The Chinese Economy Today (1)

◆ East Asia is the fastest-growing region in the world over the past quarter of a century, the East Asian currency crisis of 1997-98 notwithstanding.

◆ China is the fastest growing country in East Asia—approximately 9.4% p.a. since beginning of economic reform in 1978.

◆ Between 1978 and 2004, Chinese real GDP grew from $170 billion to $1.65 trillion (2004 prices) (6th largest GDP in the world) and real GDP per capita grew from $180 to $1,270. The U.S. GDP (approximately $11.7 trillion) and GDP per capita (approximately $39,000) are respectively more than 7 and 30 times the comparable Chinese figures in 2004.
## The Chinese Economy Today (2)

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<tr>
<th>Year</th>
<th>Real GDP</th>
<th>Real GDP per capita</th>
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<td>1978</td>
<td>170 bill.</td>
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<td>2004</td>
<td>1.65 trill.</td>
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US$ (2004 prices)
### The Chinese Economy Today (3)

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China is one of the very few socialist countries that have made a successful transition from a centrally planned to a market economy—the 10th Five-Year (2001-2005) Plan is only indicative and not mandatory; the rate of interest (the price of money) and the exchange rate are the only prices that are still administratively determined on the margin.

The private (non-state) sector accounts for more than 70% of GDP and an even greater percentage of employment in 2004.

China is no longer a “shortage” economy--insufficient aggregate demand is a real possibility.

China is not only the “World’s Factory” (surplus labor) but also the “World’s Market.”
The Macroeconomic Situation

- The Chinese economy showed signs of over-heating in selected sectors and regions in 2004. The rate of growth of real GDP for 2004 was a high 9.5%. The rate of inflation, as measured by the consumer price index (CPI) may be estimated to be 3.9% for the same period, the highest rate since the mid-1990s. However, the rate of inflation has begun to decline—it was negative for 2005Q2.
The Macroeconomic Situation

- The quarterly rates of growth of Chinese real GDP, YoY, in 2004 are respectively: 2004Q1, 9.8%; 2004Q2, 9.6%; 2004Q3, 9.1%; 2004Q4, 9.5%; 2005Q1, 9.2%; 2005H1, 9.5%.

- Judging solely from these figures on the rates of growth of real GDP, there does not appear to have been any slowdown. However, based on indicators such as the rate of growth of fixed investment, the rate of growth of commodity prices, and the rate of growth of imports, the real rate of growth of the economy should have slowed, and not continued to remain at the same high level.
The Macroeconomic Situation

- Thus, either 2004Q4 was an under-estimate or 2005Q1 was an over-estimate or both. 2005Q1 should have had a lower rate of growth than 2004Q4.
- The possible under-estimate or over-estimate is probably unintentional at the national level but might or might not have been intentional at the provincial and local levels.
- The continued apparent high rate of growth may be due to: (1) a surge due to efforts to complete projects already initiated; (2) a valuation problem of goods in process and in inventory; and (3) under-estimation in 2004Q3 and 2004Q4.
The Macroeconomic Situation

- The objectives of the central and local governments might have been different. The rate of growth reported for 2004Q4 was higher than that for 2004Q3. If the former figure were any higher, it would indicate that the macroeconomic control was mostly ineffective, which might lead in turn to a higher rate of interest. There might therefore have been some incentive for the local authorities to under-report 2004Q4.

- For 2005Q1, the figure could have been over-estimated because firms had not written down their unsold inventory of finished products and unused inventory of raw materials and intermediate inputs. It is well known that prices of many commodities (e.g., cement and steel) and products (automobiles) fell significantly during these periods. To the extent that the write-downs did not occur, the resulting GDP estimate would be an over-estimate of the true GDP.
The Macroeconomic Situation

- Efforts to engineer a soft landing has met with some success—the rate of increase of prices of certain manufactured products such as cement and steel, the rate of growth of fixed investment (2004Q1, 43%; 2004Q2, 15.7%; 2004Q3, 25.9%; 2004Q4, 20.2%; 2005H1, 25%), and the prices of real estate, have all begun to come down.
- The rate of growth of the industrial sector in 2005Q1 was 16%, down from 17% in 2004.
- The Chinese Government has demonstrated ability in macroeconomic control, albeit not relying exclusively on the mechanisms of the market.
The Macroeconomic Situation

- The “core” rate of inflation, defined as the change in the general price level net of the changes in the prices of energy and agricultural products, was always non-negative even during the period from mid-1997 to 2002. Even with the latest surge in the prices of selected commodities and products, the core rate of inflation remains low at approximately 1%. In the long run, there is no upward pressure on the real wage rate of unskilled labor. This lack of wage pressure coupled with growth in labor productivity should imply a relatively stable price level and hence relatively low rates of inflation.

- In 2005Q1, the rate of growth of money supply has been controlled at below 14%, but recently it has gone back up to above 15%.

- Inflation is likely to be manifested not in the prices of goods and services, but in the prices of assets, in particular, real estate.
International Trade and Investment

- In 2004, exports grew 35.4% to $593.4 billion; imports grew 24% to $561.4 billion; resulting in a trade surplus in goods of $32 billion, or less than 3% of total trade in goods.
- Total Chinese exports and imports of goods and services amounted to US$1.29 trillion in 2004 (US$1.15 trillion for goods alone), making China the third largest trading nation in the world, after United States and Germany.
- In 2004, China had a trade surplus in goods and services of $22.4 billion, or less than 2% of total trade in goods and services.
- In 2004, total inbound foreign direct investment (FDI) amounted to US$60 billion.
- Total foreign exchange reserves reached US$711 billion as of the end of June, 2005.
International Trade and Investment

- In 2005Q1, exports rose 35% YoY to US$156.2 billion, and imports rose 15% to US$142.7 billion, resulting in a trade surplus in goods of US$13.5 billion.
- There was some acceleration of exports during 2005Q1 and 2005Q2, mostly due to the expiration of the former textiles quotas under the Multi-Fibre Agreement and the anticipated new quota measures as well as the low base. There was a cumulative trade surplus during the period 2005M1-M7 of US$50.3 billion compared to a trade deficit of US$4.7 billion during the same period in 2004. The rate of growth of exports is expected to slow during the second half of 2005.
- Exports rose 28.7% YoY in 2005M7 while imports rose 12.7%.
Chinese Exports and Imports of Goods and Services

Chinese Exports and Imports of Goods and Services, billion US$

- Exports of goods and services (current US$ billions)
- Imports of goods and services (current US$ billions)
- Trade Balance of goods and services (current US$ billions)
Chinese Official Foreign Exchange Reserves and External Debt

Official Foreign Reserves and External Debt (US$ billions)

- Total reserves minus gold
- Long-term debt
- Short-term debt

Year

- 1978
- 1979
- 1980
- 1981
- 1982
- 1983
- 1984
- 1985
- 1986
- 1987
- 1988
- 1989
- 1990
- 1991
- 1992
- 1993
- 1994
- 1995
- 1996
- 1997
- 1998
- 1999
- 2000
- 2001
- 2002
- 2003
- 2004

Billions US$
The Hu-Wen Strategy of Economic Development

- Mr. HU Jintao, President and General Secretary of the Chinese Communist Party, has assumed total control with the retirement of former President JIANG Zemin from the Central Military Commission. Mr. WEN Jiabao, the Prime Minister, works very well with Mr. HU as a team.
- The Hu-Wen administration has shifted the emphasis of economic development from simply maximizing the rate of growth of real output (GDP) to taking into account other social welfare indicators such as employment, the quality of life, and the environment.
The Hu-Wen Strategy for Economic Development

- Rapid economic growth is not the only objective
- Encouraging thrift, conservation and efficiency
- Promoting social harmony
- Ensuring sustainability
The Three Valued Qualities of the Hu-Wen Strategy of Economic Development

- In particular, the Hu-Wen administration strives to achieve three valued qualities in its strategy of economic development:
  - **Thrift (Non-Wastefulness), Harmony and Sustainability**
- Thrift implies making do with less, including conservation, which in turn implies a more efficient utilization of scarce resources such as oil or water.
- Harmony implies a greater focus on actual and perceived fairness, less inequality of income, more redistribution, prevention of the occurrence of losers, assuring insofar as possible that every reform is Pareto-improving, i.e. is win-win for all, and the creation of hope.
- Sustainability implies the frugal and efficient use of exhaustible resources and preservation of the environment in the long term and the moderation of economic bubbles and boom and bust cycles in the short term.
Challenges for the Hu-Wen Administration

- Chinese economic reform has been most successful. Everyone is better off by a large margin compared to 1978. No one wishes to roll back the economic reform.
- However, many problems have remained and new problems have emerged: for example, the low level of household consumption (the high savings rate), the prevalence of duplicative and wasteful investment, the rising income inequality (between urban and rural, between regions, and between individuals), corruption, environmental degradation, the potential for macroeconomic instability posed by the financial sector, and the stability of the exchange rate.

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What is the best way to deal with these problems? Returning to a centrally planned system, which has proven not to work, is not a viable option (increasing complexity and scale, huge informational and monitoring requirements). The government can rely on direct administrative control only temporarily. By further perfecting the market system, many of these problems can be solved.

However, complete laissez-faire, that is, leaving everything to the market system, is not a viable option either.

In the developed market economies of the West, the governments continue to play an extremely important role in the economy and in the markets through enforcement of laws and contracts, regulation and supervision. There is also significant direct and indirect redistribution in the developed market economies.
Further Directions for Economic Reform

- In fact, the interest rates, especially short-term interest rates, and the exchange rates, are actively managed by the government in many economies (e.g., the Chairman of the Federal Reserve Board in the United States determines the short-term rate of interest through the federal funds rate).

- The ultimate goal of the Hu-Wen administration is not only to achieve rapid economic growth but also to assure efficiency, harmony and sustainability.
Encouraging Thrift, Conservation and Efficiency

- Encouraging conservation through the market (prices, non-linear pricing, taxes).
- Reducing excessive investment.
- Preventing or regulating monopolies and oligopolies and facilitating competition.
Encouraging Thrift, Conservation and Efficiency

- Relative market prices do not reflect relative scarcities. The prices of oil and energy must be marked much closer to the market to encourage conservation and efficiency.

- Non-linear pricing can be used to moderate the effect of price increases. For example, if the increase in the price of oil results in an increase in the price of electricity, low-income households can be protected by a lifeline or block pricing, e.g., the first ten kilowatt-hours of each household per month can be charged at a preferential low rate, but the eleventh kilowatt-hour can be charged the full actual marginal cost. The same concept can be applied to industrial users, distinguishing between existing usage and new usage. In time, however, the industrial users should all be brought to face the same electricity rates.
Encouraging Thrift, Conservation and Efficiency

- The retail price of gasoline in China is the lowest in the world, even lower than that in the United States. In order to encourage conservation, the price of gasoline must be allowed to fully reflect the price of oil. In addition, a retail gasoline tax should be added so as to bring the retail price of gasoline in China to the same levels as Europe and Japan. A higher retail price of gasoline does not necessarily deter the growth of the automobile industry as the experience of Germany and Japan demonstrates.

- Currently, owners of automobiles in Hong Kong drive to Shenzhen whenever they can to fill up their gasoline tanks because the price is so much lower in Shenzhen compared to Hong Kong. Energy-intensive industries, e.g., aluminum, are exporting their products on the basis of an artificially low price of electricity. China should not and cannot afford to be subsidizing consumers in other economies. All these unintended subsidies should be eliminated as soon possible.
Encouraging Thrift, Conservation and Efficiency

- Water should also be priced properly to fully reflect its marginal cost and scarcity value.
- Pollution of both air and water should carry financial as well as criminal penalties.
- In view of the hazards, coal output should be taxed to provide life and health insurance for the miners.
Reducing Excessive Investment

- Chronic excess demand for investment, especially during an economic boom is a constant feature of the Chinese economy.
- It results from moral hazard on the part of investors and enterprises that do not have to bear the financial consequences of the failures of their investment projects.
- The excessive investment during the economic boom inevitably leads to over capacity and large losses and results in a bust in the particular industry/sector.
- Thus there are cycles of large amplitudes. In this process, the marginal efficiency of capital suffers.
The Relative Ineffectiveness of Traditional Instruments

- Raising the lending rate is not effective in discouraging excessive investment (or loan demand) because of the existence of moral hazard—most borrowers are either not personally financially liable for any losses (e.g., as the executives of state-owned enterprises (SOEs)) or otherwise do not intend to repay in the case of failure of the enterprises/projects, but stand to make substantial gains in the event of success.

- While aggregate quantity constraints—whether through changes in the reserve ratio or the target for new loans—and direct administrative means may be reasonably effective, they run the risks of deterring both good and bad projects at the same time. The interesting question is:

- **Is it possible to discriminate between good and bad projects?**
Macroeconomic Stability-Enhancing Microeconomic Reforms

- The over-heating of the economy is largely due to excessive investment in certain sectors—cement, steel, automobiles, aluminum, and real estate. The over-investment is made possible not through public funding of investment (central government funded fixed investment now accounts for less than 5% of the total fixed investment in China), and only partially through improperly approved bank loans, but with the bulk of it through possibly properly approved but improperly diverted bank loans and funds.

- The objective of the microeconomic reform is to distinguish between the good projects from the bad so as to allow the good ones to proceed and the bad ones to be stopped, thus reducing excessive investment.

- Reform of the microeconomic process of loan approval and disbursement can help enormously in this regard.

- Moreover, success in differentiating between the good and bad projects will help prevent the renewed rise in the “non-performing loans (NPLs)” in the Chinese commercial banking system.
How to Reduce the Volatility of Domestic Real Fixed Investment by Enterprises?

- How to discriminate between good and bad investment projects? If good and bad investment projects can be differentiated, even in the presence of information asymmetry, it will reduce aggregate investment, temper the amplitude of the boom and bust cycle and improve the efficiency of investment (and reduce the incidence of non-performing loans). It will help to moderate “bubbles,” if any, and prevent too many bad projects from dragging down as well as driving out good projects.

- Accurate, reliable and timely information on the enterprises is essential for the reduction of the degree of information asymmetry among the different players and critical to good corporate governance. Good corporate governance can help reduce excessive investment.
How to Reduce the Volatility of Domestic Real Fixed Investment by Enterprises?

- Having more shareholders with a long-term interest in the enterprises is also essential for improving the corporate governance and hence corporate performance. (Is the presence of an active controlling shareholder good or bad—possible conflict of interest, piggy-backing and transparency?)

- One way to overcome the problems of information asymmetry and moral hazard is the requirement of a significant equity investment on the part of the borrower in the project. If the borrower is still willing to proceed with the project when he or she bears the risk of a significant financial loss, it demonstrates that the borrower is sufficiently confident of the eventual success of the project.
Reforms in the Loan Approval and Disbursement Process

- Equity requirement--in order to reduce the moral hazard of borrowers and potential borrowers, there must be a significant equity requirement up front. On investment projects, the equity requirement should be no less than 30 percent. The equity requirement must be fully paid in and retained by the commercial bank financing the project before the project can be initiated.
Reforms in the Loan Approval and Disbursement Process

- Progress method of loan disbursement—in order to prevent diversion of funds to other, non-project-related purposes, funds should be disbursed first from the initial equity deposit, and only then from the loan proceeds, and in any case only in accordance with actual progress made on the project and only to third-party contractors and sub-contractors upon independent verification of progress (e.g., payments for turbines for electricity generation should be made directly to the supplier and not to the borrower and only upon properly verified installation and acceptance). In addition to preventing diversion of loan proceeds, this also provides additional protection for the lender. In the event of a failure of the project, at least all the loan funds were spent on the project itself.
Reforms in the Loan Approval and Disbursement Process

- Since the equity requirement is expressed as a percent of the value of the entire project, reliable appraisals prior to the approval of the loans are absolutely necessary. This is especially the case if the equity consists in whole or in part of the value of the land or long-term lease contributed to the project. Trained professional appraisers are urgently needed in China.
- All of the above practices are actually common international lending practices.
Preventing or Regulating Monopolies and Facilitating Competition

◆ The easiest way for an enterprise to make a profit is to create a local monopoly or to commit fraud.

◆ Reduction of information asymmetry—quality assurance, standardization, certification, protection of brand names.

◆ Enforcement of contracts, regulations, laws and taxes
  ◆ the impracticability of self-regulation and self-enforcement in general (due to conflict of interest, mobility and the non-repetitive nature of many transactions)
  ◆ Insufficient enforcement penalizes the law-abiding enterprises and individuals

◆ Prevention and prosecution of fraud and public education (e.g., pyramid sale schemes).

◆ Integration of the national market to prevent the emergence of local monopolies.
Preventing or Regulating Monopolies and Facilitating Competition

- Regulation of monopolies
  - Technological economies of scale (electricity transmission, petrochemical plants, telecommunication services)
  - Market economies of scale (network effects, e.g., operating systems)
  - Government-sanctioned monopolies (e.g., tobacco)
- Enactment of anti-trust laws (collusion, price-fixing, cartelization, predatory pricing, tied sales).
- Externalities—pollution of air and water, global warming, congestion (e.g., automobile license fees, oil price and gasoline tax).
- In the absence of government regulation, monopoly (especially local) and cartelization are the most likely outcomes.
Coordination, Enforcement, Regulation and Supervision

- Enforcement of contracts is absolutely essential in a market economy, just as enforcement of the rights and obligations under the plan is absolutely essential in a centrally planned economy.
- Credibility of the state, and expectations thereof, affect enterprise (and household) behavior, and hence compliance with the laws and regulations (post reform).
- Full and impartial enforcement of the laws and regulations is just as important—creating a level playing field. Multiple equilibria (outcomes) are possible, depending on the credibility of state enforcement.
- Explicit or implicit self-regulation, and “regulatory capture”, should be avoided (conflict of interest).
- Regulation and supervision should be based on simple, straightforward rules, the non-compliance of which can be readily observable and verified.
Integration of National Markets

- Abolition of provincial and local barriers to the flow of goods and services.
- Reform of the procurement practices of the provincial and local governments.
- Promotion of government-supported and supervised standardization and certification.
- Protection of capital against unauthorized taxes and fees and other forms of local predation.
- Establishment of a single national commercial and tax court system with the power of enforcement to deal exclusively with commercial and tax cases, including intellectual property rights cases, with its decisions binding over the entire country.
- Enhancement of the mobility of labor.
  - Reform of the residence permit “hukou” system.
  - Portability and vesting of pension and retirement accounts.
The World Trade Organization and Openness

- Encouragement and facilitation of imports of goods and services both to spur competition and innovation (and to reduce the balance of payments surplus).
- Extension of national treatment--The WTO accession agreement provides for national treatment for all foreign enterprises. By extension, national treatment will also apply to all non-state domestic enterprises. This should facilitate mobility of capital across provinces and enhance competition and raise efficiency.
The Role of Openness

- China has had high domestic savings and investment rates. However, simply having high savings and investment rates, and hence a high rate of growth of the tangible capital input, is not enough to guarantee good economic performance. The Chinese economy prior to the beginning of its economic reform in 1978 and the former Soviet Union are two examples that a high rate of tangible capital accumulation does not guarantee a high rate of economic growth. This is where openness of the economy becomes important.

- One can distinguish between external openness and internal openness. On external openness, one can further distinguish between trade and capital flows, and on the latter, between long-term and short-term. In the Chinese case, external openness is limited to trade and long-term capital flows (including foreign direct investment).
The Role of Openness

- Openness, external or internal, has three implications. First, it allows the free flow of resources—both goods and factors (free entry and exit). Second, it promotes competition, and in some cases can substitute for regulation (e.g., a petrochemical monopoly has to compete with imports). And third, it facilitates the transfer of technology (defined broadly to include business models and methods).

- It is the competition and the free entry and exit that assure minimal economic efficiency of the investment. In the long run, only the efficient enterprises will be able to survive in an open and competitive environment.
The Role of Openness

- The long-term economic significance of Chinese accession to the World Trade Organization (WTO) is the Chinese commitment to an external open economy—guaranteeing access to imports and potential imports and foreign direct investment which in turn implies a minimal degree of competition and potential competition in the Chinese markets, putting pressure on domestic enterprises to be efficient and preventing the emergence of domestic monopolies or oligopolies.
The Role of Openness

- One reason why the East Asian newly industrialized economies have been able to allocate its investment relatively efficiently is because of their export orientation. In the export sector, enterprises have to compete with other enterprises in the rest of the world and the assistance of their own governments has only very limited effects. They just have to be efficient to survive.
The Role of Openness

- Internal openness creates space for non-state-owned enterprises (initially Township and Village Enterprises) in China to grow and prosper. Non-state-owned enterprises tend to be more efficient not because they are necessarily run by smarter people, but because they tend to correct their mistakes sooner. Non-state-owned enterprises make their share of bad investments, however, they close down bad investments very quickly, unlike state-owned enterprises with their deep pockets and where the incentives are different and the enterprises are subject to only a soft-budget constraint.

- The effects of openness are magnified by the increasingly rapid rate of globalization, facilitated by the revolutionary advances in the information and communication technology.
Promoting Social Harmony

- Promoting social harmony implies:
  - Guaranteeing the satisfaction of the most basic needs
  - Avoiding and minimizing the creation of losers
  - Protection of the weak and downtrodden in society
  - Providing a social safety net
  - Ensuring the actual and perceived equity and fairness of the distribution of income
  - Redistribution of income wherever appropriate and necessary
  - Assuring the equal access to opportunities
  - Fair and impartial administration of justice and equal treatment before the law
  - Enabling economic and social mobility and creating hope
Promoting Social Harmony

◆ A society must strike a balance between efficiency and equity. Redistribution, in particular, lumpsum redistribution, is actually not incompatible with efficiency. Efficiency only requires that economic agents face identical prices on the margin. Different inframarginal prices do not affect efficiency.
◆ Perceived equity and fairness are fundamental to long-term social harmony and stability.
Promoting Social Harmony

- Short-term redistribution can be implemented through direct transfer payments.
- Intermediate-term redistribution depends on the establishment of a **credible** social safety net, the institution of a progressive comprehensive individual income tax, and the full implementation of the rule of law in the economic sphere—protection of labor and land rights as well as other tangible and intellectual property rights.
- Long-term redistribution can be done through the investment in education and human capital especially in the poor areas of the country. It is the proven most effective means for alleviating poverty and reducing income inequality permanently.
  - Universal secondary education as a goal
  - Central government back-stop of educational expenditures for provinces/municipalities/regions with low per capita GDP
  - Ensuring equal access for all
Promoting Social Harmony

- It enables citizens to take care of themselves; narrows the inequality in the income distribution; and greatly improves employability in the long term.
- It therefore reduces long-term social costs, enhances social harmony and strengthens long-term sustainability.
- Investment in infrastructure is also a form of redistribution, e.g., mass transit system financed from taxes on gasoline; schools, parks, hospitals and other public facilities built with general revenue.
- Universal basic social insurance can also be financed through general tax revenue.
- Bringing capital and jobs to labour rather than labour to capital and jobs—industrialization and urbanization in situ.
Improving Labour Conditions and Protection of Labour Rights

- Full monetization of compensation.
- Enhancing mobility (portable pension and health care plans, national accreditation).
- Delinking government and enterprises—salary structure (raising the salaries of civil servants is a high priority), benefits, security of tenure
- Restoring the rights of hiring and firing to the enterprises
- Protection of workers’ legitimate rights (regulation of monopsonistic power in the labor market)—e.g. workers in the coal mining industry
- Ensuring safety of the work place
- Requirement of insurance for workers in hazardous occupations
Protection of Property Rights--Land

- Development of a national universal land registration system.
- Defining, affirming and protecting the use and transfer rights of leaseholders, especially the land rights of the peasants, including their personal residences.
- Vesting of transferable lease rights on farm land to farmers—effective ownership rights with full compensation upon change of use or retirement—the land use rights are an asset that can be used to finance the retirement of peasants.
- More transparent land use planning, open public auctions of land parcels, and use of eminent domain only with fair compensation.
Enhancing Individual Security and Reducing Risk

- Completing the markets for contingent commodities reduces the risks faced by individual households and enterprises and lowers the precautionary savings that must be maintained. This is the key to increasing domestic consumption and reducing the savings rate.

- Social security reform
  - Pension
  - Unemployment

- Health care financing

- Futures markets
Maintaining a Positive Real Rate of Interest

- It is important to maintain a positive real rate of interest on deposits—otherwise there will be disintermediation, i.e., deposits being withdrawn from the commercial banks. (It is also important to maintain a positive real rate of interest on loans, but as long as there is a positive real rate on deposits, there should be a positive real rate on loans, given the required positive spread.) Given the level of non-performing loans in the Chinese commercial banks, China cannot afford the risk of disintermediation.
- Financial disintermediation may actually encourage underground financial institutions that are much more difficult to monitor and control.
- A negative real rate of interest on deposits undermines confidence in the currency and the commercial banks in the long run.
Maintaining a Positive Real Rate of Interest

- A chronically negative real rate of interest on deposits has undesirable consequences of incidence—it redistributes from the net depositors, who are mostly low-income individuals, to the net borrowers (enterprises and wealthy and high-income individuals), worsens the distribution of income, and threatens social stability.
Maintaining a Positive Real Rate of Interest

◆ There was a run on the commercial banks and a buying panic in August 1988 precisely because of the negative real rate of interest on deposits at the time.

◆ It may be useful for China to introduce indexed government securities similar to the Treasury Inflation-Protected Securities (TIPS) of the United States, both as an inflation hedge for Chinese citizens and as an indicator of inflationary expectations in the market.
Using the Market to Combat Corruption

- Discretion is the source of all corruption—by relying on the open market as much as possible, the possibility of corruption is minimized. For example, business franchises (e.g., taxi licenses) can be granted through open public auctions.
- Corruption, when found, must be prosecuted to the fullest to provide an example so that future cases may be deterred.
Reducing Regional Inequality: The Development of the Great West

- Even though all regions benefited from the economic reform since 1978, the coastal regions benefited much more than the inland regions—there is an estimated 6 to 1 or even 8 to 1 ratio between the per capita GDP of the richest and poorest province/region.
- Interregional income inequality has risen, resulting in:
  - Dissatisfaction and restiveness
  - Deterioration of social services, especially education and health care
  - Massive illegal migration from the inland regions to the coastal regions, creating huge pressure on social and physical infrastructure
Reducing Regional Inequality
The Development of the Great West

- Relaxation of rural-urban migration (mostly controlled by the local authorities)
- Transfer payments from the central government
- Raising agricultural incomes (reduction of agricultural taxes; standardization and quality assurance so as to facilitate direct trade between producers and users; introduction of competition among middlemen)
The Development of the Great West: Reducing Regional Inequalities

- Urbanization in situ through the creation of new towns and cities, not the growth of existing towns and cities--Moving investment and jobs to where people are, not people to where jobs are
- Investment tax incentives for poor provinces/municipalities/regions based on per capita GDP
- Maintaining long-term competitiveness: WTO accession can help by putting pressure on enterprises to move inland to lower their costs and maintain competitiveness
- Opening a new “Silk Road”—a direct land bridge to Europe and the relocation of the capital from Beijing to a city in the Western region of China can significantly accelerate the development of the Great West
Reducing Regional Inequalities: Rejuvenation of the Northeast

- The Northeast is China’s “Rust Belt”.
- Its conditions are much better than the West—it has a strong industrial base and a very productive agriculture.
- What is needed is greater promotion of the private (non-state) sector—more local initiatives, less reliance on government and less regulation.
Maintaining Stable International Economic Relationships

◆ Social harmony is promoted by preserving low-wage jobs and protecting farm income. An appreciation hurts both.
◆ Neither a wildly fluctuating exchange rate, nor a continually appreciating exchange rate contribute to long-term sustainability of economic growth.
Maintaining Stable International Economic Relationships

- The exchange rate should be managed so as to assure long-term equilibrium of the balance of payments independently of the hot money inflows and outflows. As long as there is only a small current account surplus or deficit, there is no need to change the exchange rate.
- Increasing imports (strategic reserves; import financing and facilitation; flags of convenience)
- Reducing exports (as an alternative to an exchange rate revaluation) by imposing an export tax or by reducing or even eliminating rebates of VAT or import duties paid on the inputs used for the production of exports. The latter is to ensure that there is a level playing field between domestically produced inputs and imported inputs. If there is reduced or zero rebate of value added taxes paid on the use of domestically produced inputs, there should also be zero rebate of similar taxes paid on imported inputs.
- Facilitating orderly outflow of capital; strengthening inbound capital controls.
Ensuring Sustainability

- The use of exhaustible resources (oil, water)
- Maintenance of macroeconomic stability
- Ensuring stability of the exchange rate to facilitate international division of labor
The Sources of Macroeconomic Instability: Boom and Bust Cycles

- The macroeconomic instability in China is caused primarily by boom and bust cycles in real fixed investment undertaken by enterprises, public and private. These boom and bust cycles are driven mostly by domestic demand and not by external disturbances.
- Because of moral hazard, a boom inevitably leads to excess capacity and low investment returns, sowing the seeds of a subsequent bust and a decline in real fixed investment by enterprises—hence a boom and bust cycle.
- Bad investments result in lower rates of return not only for themselves but for otherwise good investments through their competition for resources (capital, raw materials, talents, markets).
The Sources of Macroeconomic Instability: The Spillover Effects

- The macroeconomic instability in China can also be caused by the spillover (domino) effects of failures of large enterprises propagating through the economy.
- Because of the high debt-to-equity ratios, enterprises are much more prone to fail, and when an enterprise fails, it may drag down otherwise sound enterprises—suppliers and financial institutions, with it, setting off a domino effect.
- It is important in the long run to maintaining a positive real rate of interest on loans. A negative real rates of interest on loans encourage moral hazard and the excessive use of debt.
Reducing the Debt/Equity Ratio

More generally, the imposition of an equity requirement on loans will lower the debt/equity ratio of Chinese enterprises as well as the overall debt/equity ratio of the Chinese economy, greatly enhancing its stability by reducing the spillover effects of the failure of large enterprises/projects.

The newly re-opened Small and Medium Enterprises Board on the Shenzhen Stock Exchange is a welcomed move in the promotion of more equity and less debt in the Chinese economy and also provides alternative investment outlets for individual Chinese citizens and lessens the demand on real estate.
Reducing the Debt/Equity Ratio

- The Chinese Government can also do more to promote the use of equity financing by enterprises by eliminating the double taxation of corporate dividends (through making cash dividends of listed companies deductible against corporate income) and thus removing one bias against equity financing by enterprises.
- Lowering the leverage also reduces moral hazard—enterprises will be risking more of its own money rather than the banks’ money and have a greater incentive to be prudent with their investments.
Enhancing the Stock Market as an Allocator of Capital

- Creating new supply and new demand
- Attracting institutional and long-term individual investors
- Improving enterprise governance
- Cash dividends both to enhance attractiveness of common stocks and as a signaling device
- The listing and trading of foreign and Hong Kong stocks as China Depository Receipts and baskets of foreign and Hong Kong securities in Renminbi. This also helps to alleviate the problem of excessive foreign exchange reserves without causing large short-term cross-border flows of foreign exchange.
The Sources of Economic Growth-- Developing Economies

- Different types of measured inputs play different roles at different stages of economic growth
- Tangible capital accumulation is the most important source of growth in the early stage of economic development
- But simply accumulating tangible capital is not enough--it must also be efficiently allocated
- Efficient tangible capital accumulation is the major accomplishment of the East Asian NIEs in the postwar period
  - Market-directed allocation of new investment, aided by export orientation, promotes efficiency
  - Private enterprises have the incentives for prompt self-correction
- Intangible capital accumulation becomes important only after a certain level of tangible capital per worker is achieved but has begun to be important for some East Asian NIEs such as South Korea and Taiwan
The Sources of Economic Growth--China

- Chinese economic growth over the past quarter of a century has been mostly driven by the growth of inputs, principally tangible capital (structures, equipment, and physical infrastructure) and not by technical progress or growth in total factor productivity.

- The growth of tangible capital accounts for the bulk (90 percent) of the measured economic growth in China. The tangible capital stock has been growing at approximately 15 percent per year.

- Moreover, the differences in the levels of real GDP per capita between China and the other economies can be largely explained by the differences in the tangible capital and human capital per unit labor.
Real Output per Labor Hour (1980 US$)
Tangible Capital Stock per Labor Hour (1980 US$): Selected Economies
Human Capital per Labor Hour (Years of Schooling): Selected Economies

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Average Human Capital (Years/Working-Age Person: Selected Economies)
The Fundamental Importance of Domestic Savings

- The bulk of the gross domestic investment in China is financed by domestic savings. Foreign direct investment accounts for approximately 10% of gross domestic investment in China. While helpful, foreign direct investment and foreign loans alone cannot sustain the rapid economic growth of China.

- This underscores the fundamental importance of domestic savings in Chinese economic growth--without the domestic savings financing the investment, the growth of the tangible capital input would not have been possible; and without the growth of the tangible capital input, the growth of real output would not have been possible.
The Advantages of a High Domestic Savings Rate

- Except for a short early start-up period in the early 1950s, the Chinese domestic savings rate has always been high, on the order of 30 percent. In recent years, it has approached 40-50%.

- A high domestic savings rate makes possible a high domestic investment rate. In addition, it has other advantages.
The National Savings Rates of Selected Economies

National Savings Rates of Selected Countries and Regions

- Brazil
- Canada
- China
- France
- Hong Kong, China
- India
- Indonesia
- Italy
- Japan
- Korea, Rep.
- Mexico
- Philippines
- Singapore
- Thailand
- United States
- Taiwan

- 1975
- 1998
- 2001

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The Savings Rate as a Percent of GDP: Selected Countries and Regions

The Savings Rate as a Percent of GDP

<table>
<thead>
<tr>
<th>Year</th>
<th>Hong Kong, China</th>
<th>India</th>
<th>Korea, Rep.</th>
<th>Malaysia</th>
<th>Singapore</th>
<th>Thailand</th>
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The Savings Rate and Real GDP per Capita: East Asian Economies

National Savings Rate and Real GDP per Capita

- China
- Hong Kong
- Indonesia
- Japan
- Korea, Republic of
- Malaysia
- Philippines
- Singapore
- Thailand
- Taiwan

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The Advantages of a High Domestic Savings Rate

- A country with a high savings rate does not need to rely on foreign savings—does not need to borrow abroad and bear the potential risks of a large, and often interruptible, foreign-currency denominated debt.

- With new resources being made available each year from new savings, enabling new investments to be made, the necessity of restructuring and redeploying existing investment is greatly diminished (thus making it more possible to avoid creating losers).

- Moreover, with a high domestic savings rate, the non-state sector (which is generally more efficient) can grow without significant, possibly socially disruptive, large-scale privatization.
China’s Gross Domestic Investment as a Percent of GDP

China's Gross Domestic Investment as a Percentage of GDP

Year

Percent


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The Advantages of a High Domestic Savings Rate

- Latin American economies are the chronic sufferers of a low domestic savings rate. They are therefore forced to augment their domestic savings by borrowing abroad in foreign currency. But loans have to be repaid sooner or later. When that happens, economic growth cannot be sustained; and often currency crises will result.
- The low domestic savings rate in Russia made it necessary for Russia to privatize and restructure, a process which resulted in approximately a decade of declining real GDP and the creation of many losers.
R&D Expenditures as a Ratio of GDP: G-7 Countries, 3 East Asian NIES & China

Figure 8.1: R&D Expenditures as a Percentage of GDP: G-7 Countries, 3 East Asian NIEs and China
R&D Expenditures: China

China’s R&D Expenditure and Its Share of GDP

- **Bilion Yuan**
- **%**

- **R&D Expenditure**
- **R&D as a Percentage of GDP**


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R&D Capital Stocks: G-7 Countries and 3 East Asian NIEs

Figure 8.2: R&D Capital Stocks in Billions of 1980 U.S. Dollars

- U.S.
- Japan
- W. Germany
- U.K.
- France
- Canada
- Italy
- South Korea
- Singapore
- Taiwan
Figure 8.3: Patents Granted Annually in the United States: G7 Countries, 4 East Asian NIEs and China
Figure 8.4: The Number of U.S. Patents Granted Annually vs. R&D Capital Stocks

- US
- Japan
- West Germany
- UK
- France
- Canada
- Italy
- South Korea
- Singapore
- Taiwan

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Additional Advantages of the Chinese Economy

◆ A large internal market
  ◆ A large internal market permits the realization of economies of scale.
  ◆ A large internal market also allows a significant influence on the development and setting of standards.
  ◆ A large internal market also enhances the returns to R&D and other forms of intangible capital.

◆ An almost unlimited supply of surplus labour—there will not be any pressure on the real wage rate of unskilled labour for decades to come.

◆ The advantages of backwardness—the ability to learn from the successes and failures of other economies; the ability to leap-frog stages of development; the possibility of creation without destruction.
Long-Term Economic Growth: Three Paradigms of Chinese Economic Growth

- Domestic demand-driven growth--the domestic market paradigm a la the United States in the 19th century. China is a large continental economy--International trade will never be as important as other, smaller countries and China must rely on internal demand for further economic growth. Value-added from exports constitutes only 7.5 percent of Chinese GDP.

- The "wild-geese-flying pattern" metaphor of East Asian industrial migration over time can apply to Chinese provinces and regions

- Privatizing the economy without privatization--shrinking the state sector through the growth of the non-state sector in the absence of explicit privatization--the experience of Taiwan and South Korea
Long-Term Economic Growth: Three Paradigms of Chinese Economic Growth

◆ What does it take?
  ◆ Availability of infrastructure (transportation and communication, including the internet)
  ◆ Continued marketization of the economy
  ◆ Maintenance of a domestically open economy (the equivalent of the “interstate commerce” clause of the U.S. constitution)
  ◆ Affirmation of tangible and intangible property rights and the rule of law (a national commercial and tax court?)
  ◆ Maintenance of an internationally open economy--the role of the "open door" (WTO)
Long-Term Economic Trends

◆ Aggregate GDP
  ◆ The Chinese economy is likely to continue to grow, more or less independently of what happens in the rest of the world, over the next several decades at an average annual rate of approximately 7%
  ◆ The source of this growth will come primarily from tangible capital accumulation, supported by a national savings rate of 40%, human capital accumulation, and economies of scale, and to a lesser extent on the growth of intangible capital (for example, R&D capital) and improvements in efficiency
  ◆ By 2020, aggregate Chinese GDP will exceed the aggregate GDP of Japan (and approximately half of aggregate U.S. GDP)
  ◆ By 2035, aggregate Chinese GDP will reach the same level as aggregate U.S. GDP
Long-Term Economic Trends

◆ Per capita GDP
  ◆ However, Chinese GDP per capita will only reach US$10,000, or approximately 20% of U.S. GDP per capita, in 2035
  ◆ Chinese GDP per capita will approach the level of U.S. GDP per capita only beyond 2050

◆ Population
  ◆ By 2035, India will have overtaken China as the most populous nation in the world

◆ The currency
  ◆ The Renminbi will in time become one of the strongest currency in East Asia and a quasi-reserve currency like the Euro
## Long-Term Projections

<table>
<thead>
<tr>
<th>Year</th>
<th>Real GDP (2004 prices)</th>
<th>Real GDP per capita</th>
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</thead>
<tbody>
<tr>
<td>2004</td>
<td>1.65 trillion</td>
<td>1,270</td>
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<td>2010</td>
<td>2.4 trillion</td>
<td>1,800</td>
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<tr>
<td>2020</td>
<td>4.8 trillion</td>
<td>3,500</td>
</tr>
</tbody>
</table>
The Structure of the Economy: GDP

2001
- Primary Sector: 33.6%
- Secondary Sector: 15.2%
- Tertiary Sector: 51.1%

2020
- Primary Sector: 7.5%
- Secondary Sector: 47.2%
- Tertiary Sector: 45.2%
The Structure of the Economy: Employment

- **2001**
  - Primary Sector: 27.5%
  - Secondary Sector: 22.5%

- **2020**
  - Primary Sector: 25.0%
  - Secondary Sector: 48.0%
  - Tertiary Sector: 27.0%
Potential Risk Factors

- Will there be a soft landing?
- Financial stability
  - The Banking Sector (Non-Performing Loans, Pyramid Schemes, Real Estate Bubble)
  - The Stock Market
- Social Stability
  - The social safety net—pension, healthcare, unemployment
  - Corruption
- Exchange rate mechanism (capital flight, abolition of capital control)
- Taiwan Straits
- China-U.S. relations
Concluding Remarks

- A soft landing is achievable. My own personal forecast is a rate of growth of real GDP of 8% and a rate of inflation of 3% for 2005, followed by a rate of growth of 7% and a rate of inflation of 2% for 2006.
- If the boom and bust cycles can be moderated through a more careful screening of investment projects and the spillover effects can be minimized through a decrease in the debt to equity ratio, the macroeconomic stability of China can be greatly enhanced.
Concluding Remarks

♦ The prospects for continued rapid growth of the Chinese economy in the foreseeable future are excellent.
♦ The high domestic savings rate implies a high rate of capital accumulation. The abundant supply of surplus labor implies a low and steady real wage rate and keeps the marginal productivity of capital high. A continuing high rate of growth of real output is the result.
♦ The low external debt (coupled with capital control) and the existence of significant state-owned assets minimize the probability of a major economic crisis.
Prospects for Economic Growth

Chinese economic growth during the next five years, indeed the next decades, will depend mostly on internal factors and be largely unaffected by the policies of other countries or events outside of China (a disruption of the oil supply may be an exception).

There are numerous serious problems confronting the Chinese economy—however, these problems are not intractable.

On the margin, foreign involvement in the Chinese economy will make some, but not a critical, difference; but it can be mutually beneficial for both China and the foreign countries.
Prospects for Economic Growth

- Chinese GDP and GDP per capita will remain low relative to the industrialized economies (G-7) for at least three or more decades.
- Chinese GDP per capita will reach the level of the U.S. only by the end of the 21st Century.
- The share of Chinese GDP produced by the non-state-owned sector will rise from 70% to 80% in another decade.
- There is significant complementarity between the Chinese and G-7 economies--the G-7 economies do not export anything that China exports (and have not done so for decades) and China does not export anything that the G-7 exports. It is this complementarity that maximizes the potential gains from free trade between the two sides.
Concluding Remarks

- Further economic reform is needed to assure efficiency, harmony and sustainability.
- The proposed economic reform measures are feasible but require careful implementation to minimize the unnecessary creation of losers and to allow a smooth transition so as to maximize support and minimize opposition.
- In the long run it is important for China to strive to become a land of hope and opportunity, a land in which everyone has a realistic and realizable opportunity to improve his or her life.