

Perspectives on the Chinese Economy

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Introduction

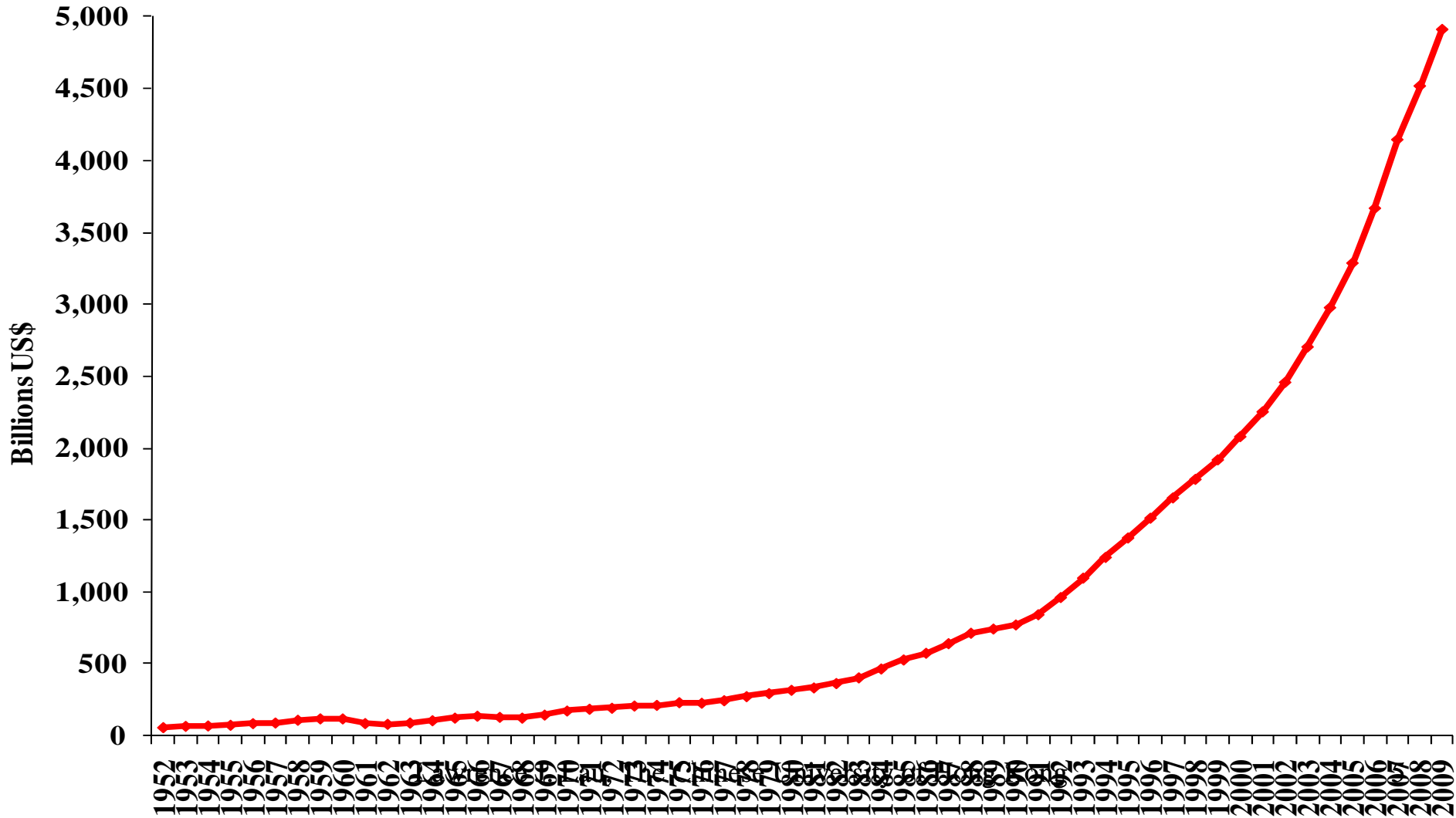
- ◆ China has made tremendous progress in its economic development since it began its economic reform and opened to the world in 1978. China is currently the fastest growing economy in the World—averaging approximately 10% per annum over the past 30 years.
- ◆ Between 1978 and 2009, Chinese real GDP grew 18 times, from US\$274 billion to US\$4.91 trillion (2009 prices) (3rd largest economy in the world) and real GDP per capita grew more than 13 times, from US\$284 to US\$3,681. By comparison, the U.S. GDP (approx. US\$14.26 trillion) and GDP per capita (approx. US\$46,100) were respectively 3 and 12.5 times the comparable Chinese figures in 2009.³

Introduction

- ◆ China has survived the East Asian currency crisis of 1997-8 as well as the global financial crisis of 2007-8 reasonably unscathed.
- ◆ The Chinese economy grew 8.7% in 2009 and 11.9% year-over-year in the first quarter of 2010 even though the European and U.S. economies remained in recession.
- ◆ If current trends continue, Chinese GDP will approach the level of U.S. GDP in less than 20 years' time, some time between 2025 and 2030.

Real Chinese GDP in US\$ Since 1952 (2009 Prices)

Chinese Real GDP, in 2009 prices

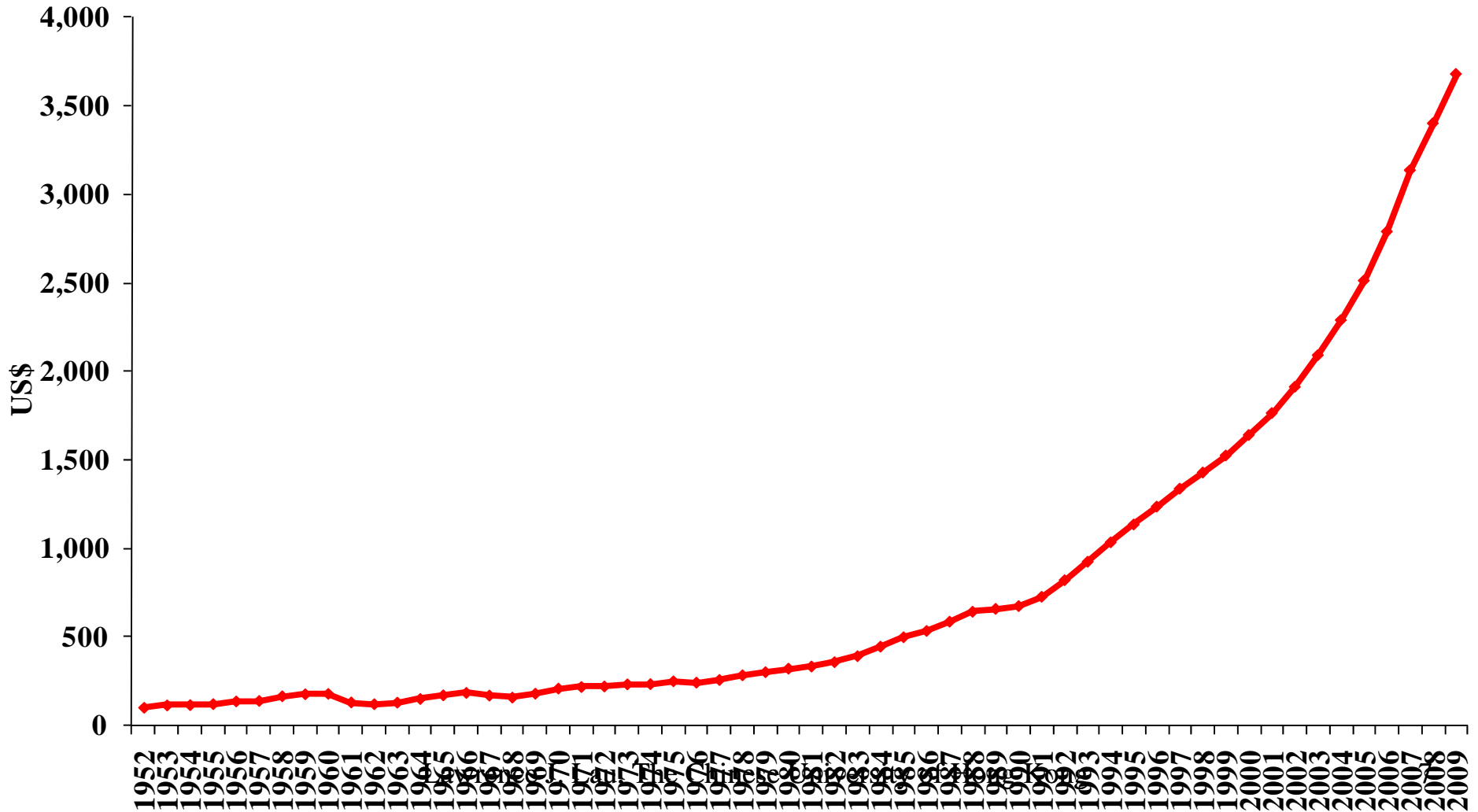


Introduction

- ◆ However, despite its rapid growth, China is still a developing economy in terms of its real GDP per capita. An economy is generally considered to be developed if its GDP per capita exceeds US\$10,000 (if we take into account inflation, this threshold should probably be much higher).
- ◆ It will probably take another 20 years before China joins the ranks of developed economies, achieving a per capita real GDP of US\$10,000, and a further 20-25 years before China reaches the same level of real GDP per capita as the United States, some time past the middle of the 21st Century (bear in mind that in the meantime the U.S. economy will also continue to grow, albeit at rates significantly lower than those of China and that the Chinese population will reach a peak in 2035 and then begin to decline slowly).

Real Chinese GDP per Capita in US\$ Since 1952 (2009 Prices)

Chinese Real GDP per Capita, in 2009 prices

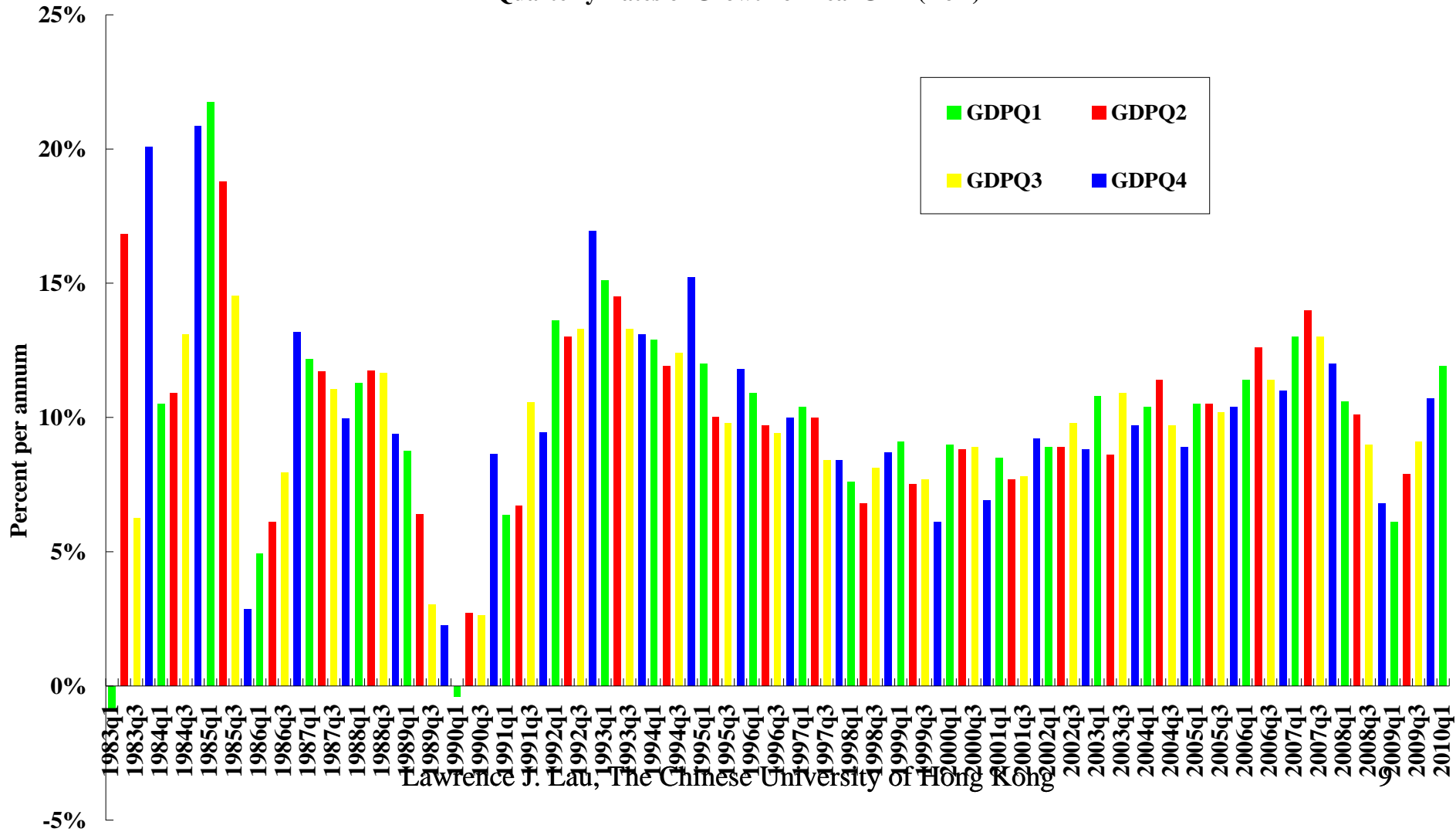


The Chinese Real GDP and Real GDP per Capita: Past, Present and Projected Future

	1978	2009	2020
	US\$	(2009 prices)	
Real GDP (trill.)	0.274	4.91	10.00
Real GDP/capita	284	3,681	7,000

Quarterly Rates of Growth of Chinese Real GDP, Y-o-Y

Quarterly Rates of Growth of Real GDP (YoY)



Is the Renminbi (Yuan) Under-Valued?

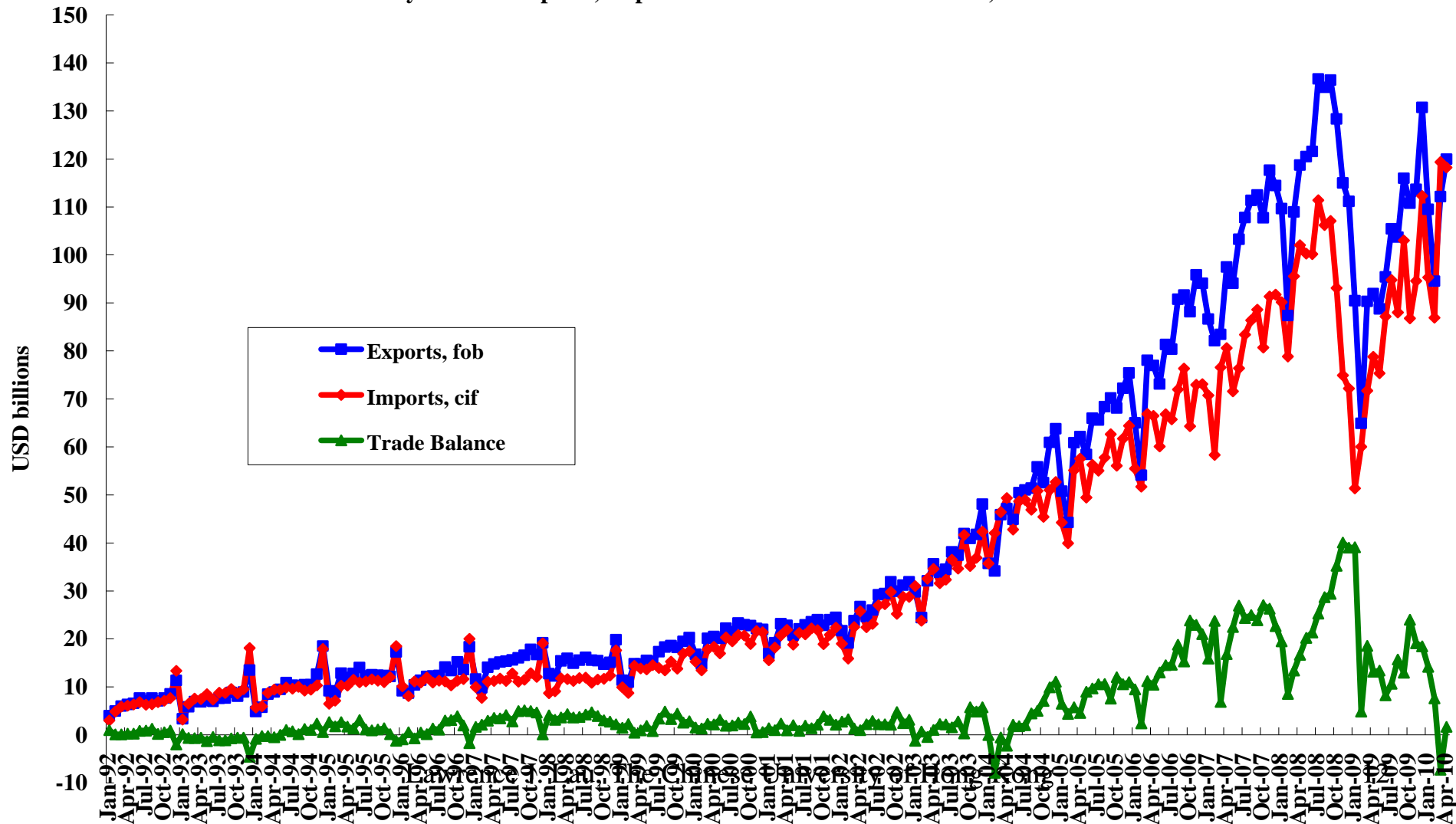
- ◆ A country's currency is considered under-valued if it runs persistent surpluses in trade in goods and services combined vis-à-vis the entire World. It is considered over-valued if it runs persistent trade deficits vis-a-vis the World.
- ◆ A bilateral trade surplus, even a persistent one, says nothing about whether a country's currency is under-valued because it may still have a near zero or even negative trade balance vis-à-vis the entire world. Most non-oil producing countries have persistent bilateral trade deficits with oil-exporting countries. And that does not necessarily mean the currencies of the oil-exporting countries are under-valued.

Is the Renminbi (Yuan) Under-Valued?

- ◆ The statistics on Chinese trade balances over the past three decades indicate that China has had essentially balanced trade in goods and services combined with the World until 2005 and that its trade surplus has once again become insignificant beginning in early 2010.
- ◆ In contrast, the large U.S. trade deficit with the world existed since at least 1998, long before 2005. What this means is that while there is evidence that the U.S. Dollar might have been over-valued, there is no evidence that the Renminbi was under-valued prior to 2005.

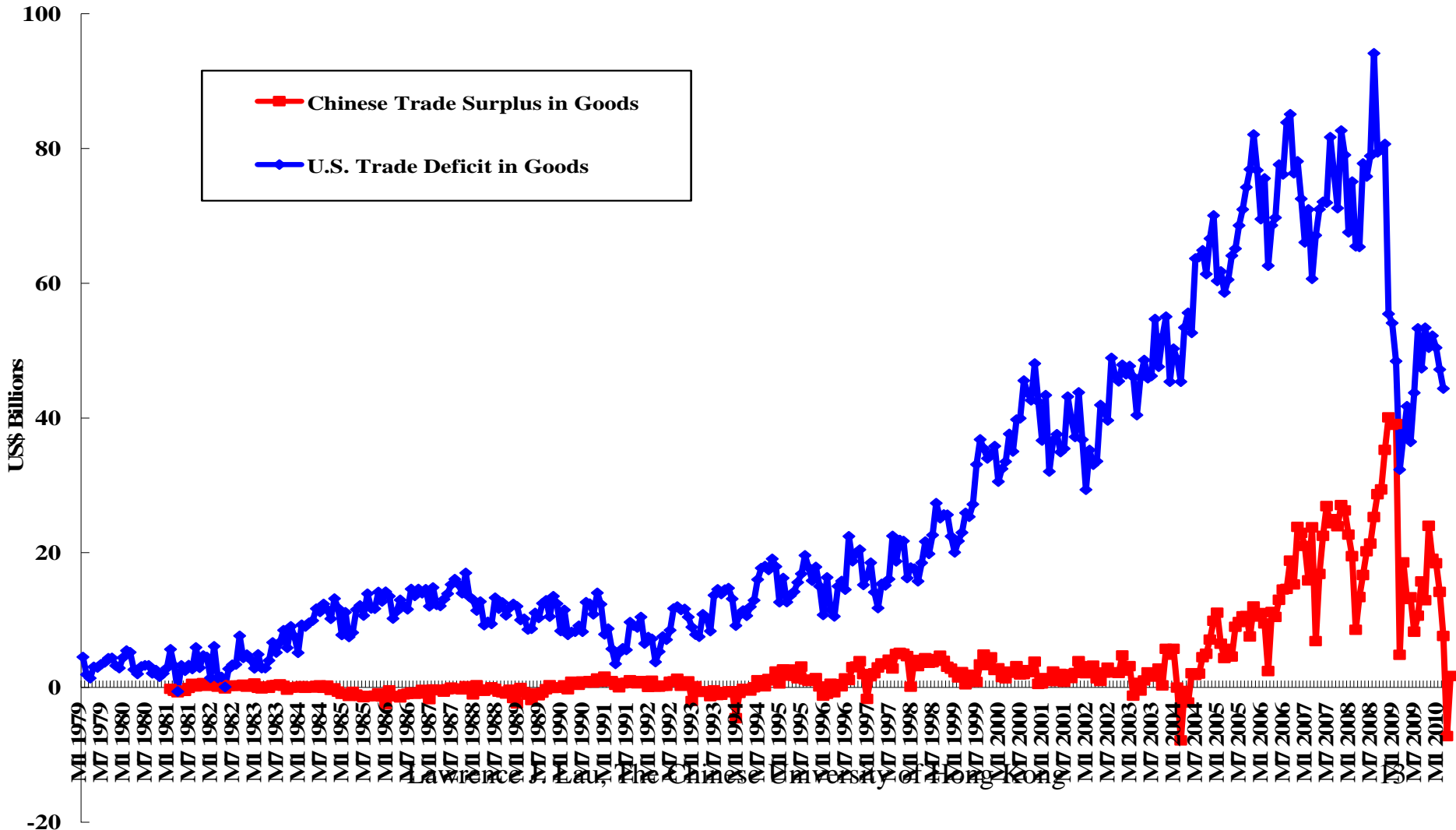
Chinese Monthly Exports, Imports and Trade Balance, US\$

Monthly Chinese Exports, Imports and Trade Balance of Goods, in U.S. Dollars



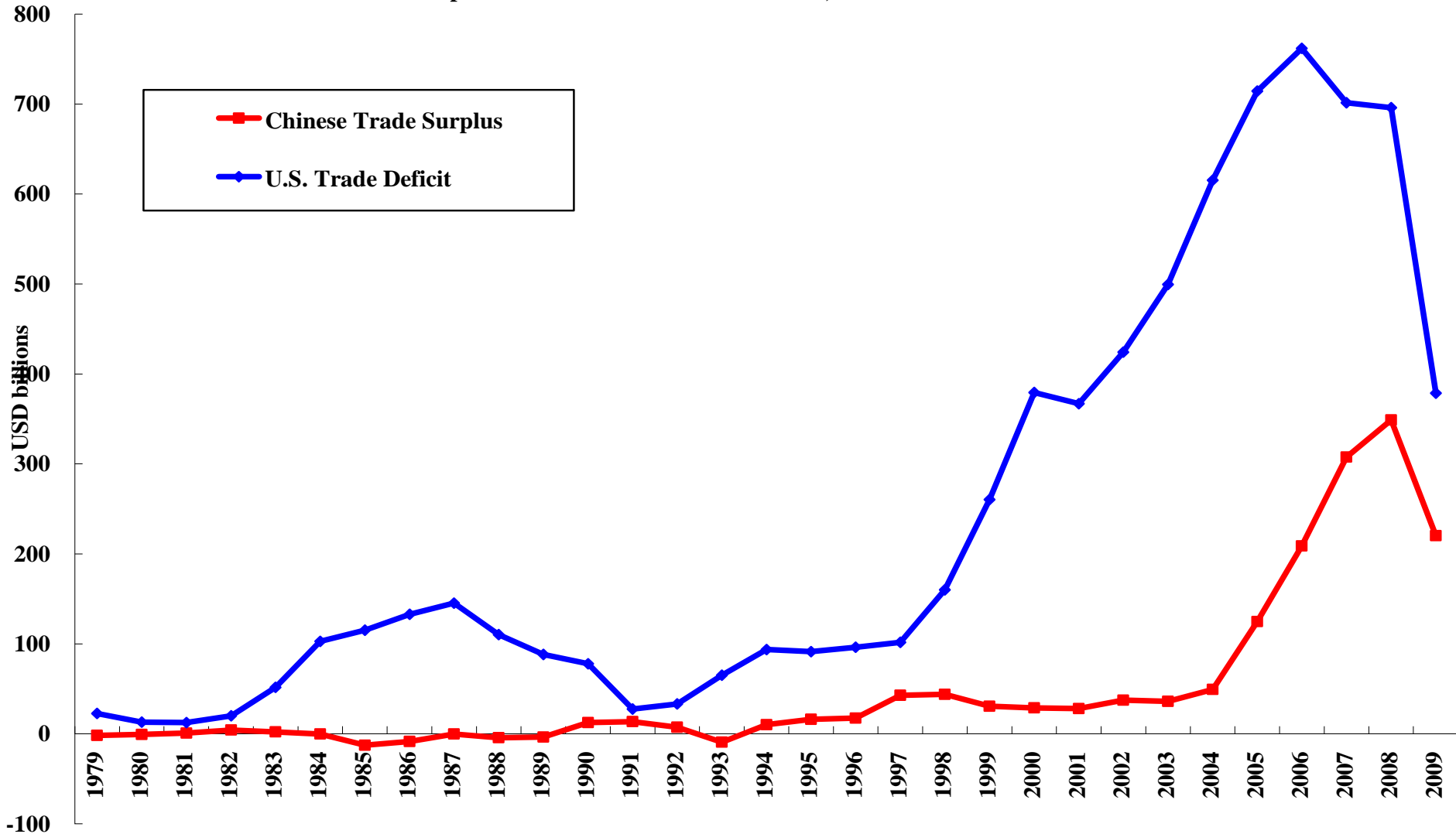
Monthly Chinese Surplus and U.S. Deficit with the World, Trade in Goods, Bill. US\$

Monthly Chinese Surplus and U.S. Deficit with the World, Trade in Goods, Billion US\$



Chinese Surplus and U.S. Deficit with the World, Trade in Goods and Services

Chinese Surplus and U.S. Deficit with the World, Trade in Goods and Services

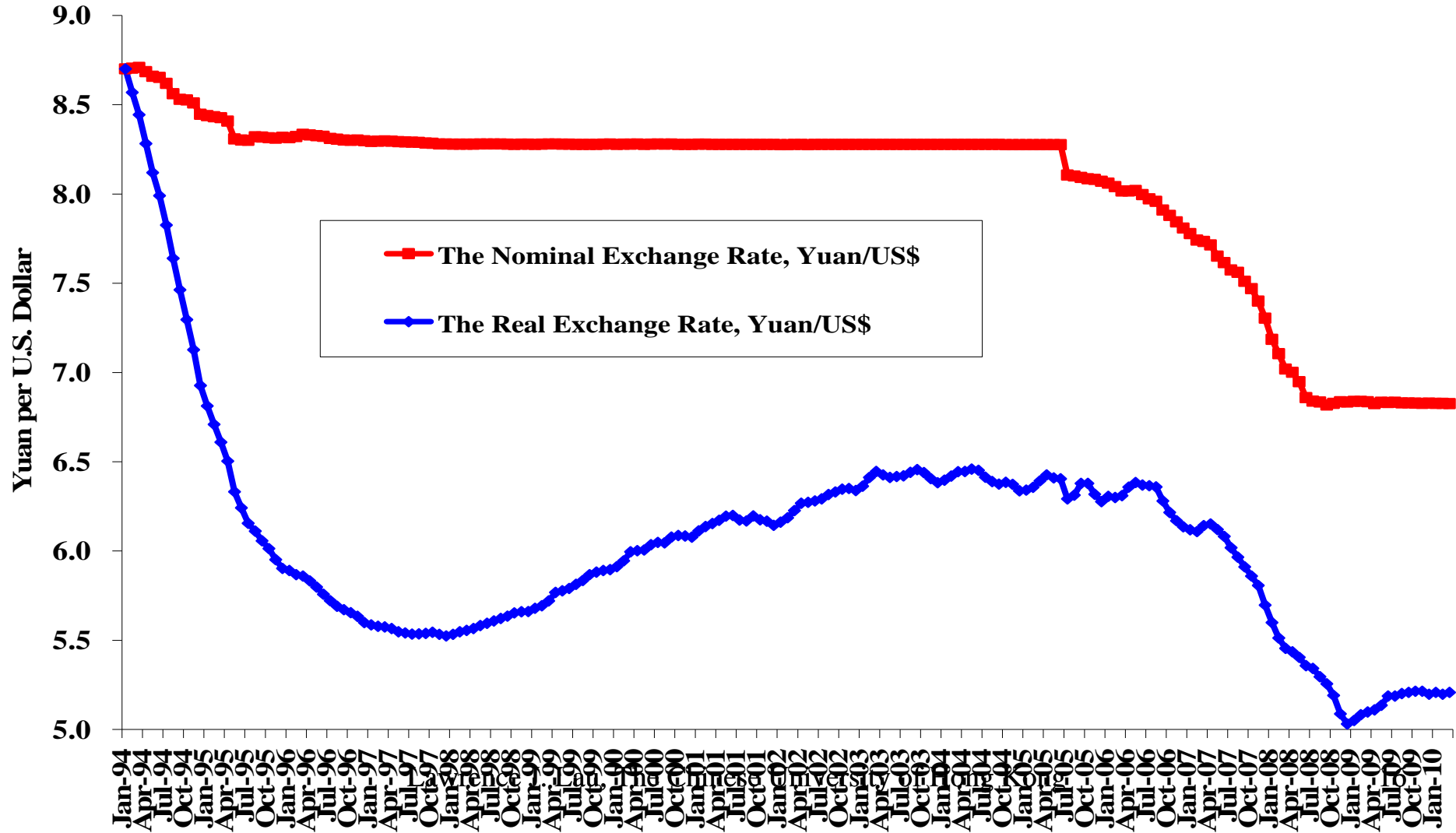


Is the Renminbi (Yuan) Under-Valued?

- ◆ In July 2005, the Renminbi was allowed to appreciate and rose 20 percent in nominal terms and 25 percent in real terms by the end of 2008.
- ◆ The Chinese trade surplus vis-à-vis the world, which began rising in 2005, reached a peak in 2008 when it began to decline rather precipitously. For 2009, it declined more than 30%. It has continued to fall and turned negative in March 2010 and continued to stay low in April 2010.
- ◆ The long-term goal of the Chinese Government is to reduce the Chinese trade surplus vis-à-vis the World to zero. If the current trend continues, the goal of zero annual trade balance can probably be achieved by 2011, without necessarily any large adjustment in the nominal Yuan/U.S. Dollar exchange rate.

The Nominal and Real Yuan/US\$ Exchange Rates

The Nominal and Real Exchange Rates (1994 prices), Yuan/US\$



Did the Chinese Trade Surpluses Cause the Global Imbalances ?

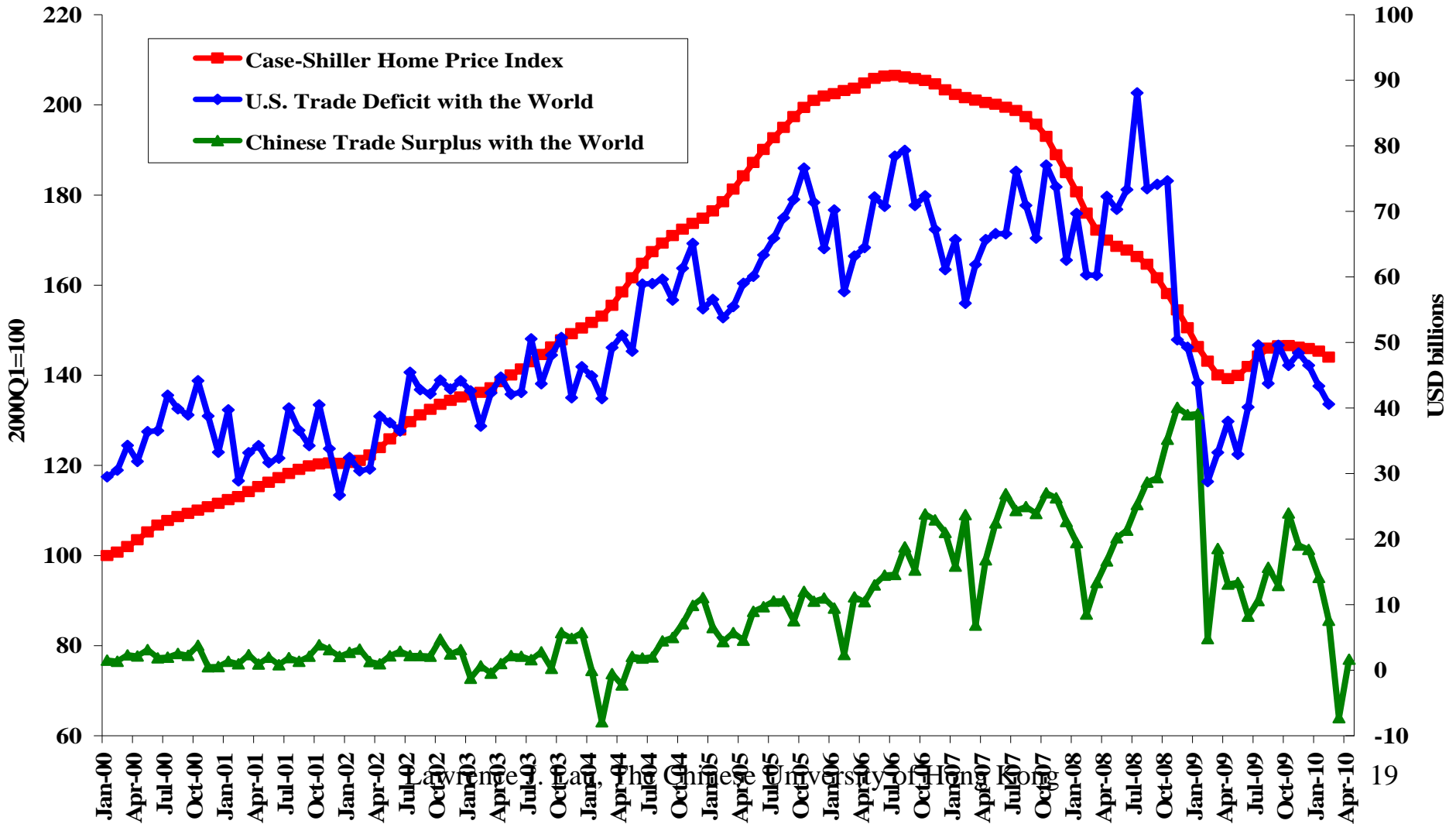
- ◆ Global imbalances are blamed as a major cause of the current global financial crisis and Chinese trade surpluses are blamed as a source of these imbalances. However, the large U.S. trade deficit with the World has existed since 1998, long before China began to have a significant trade surplus vis-à-vis the world. In 2000, U.S. trade deficit was US\$380 billion whereas the Chinese trade surplus was only less than US\$30 billion. Thus, the Chinese trade surpluses could not possibly have been the source of the global imbalances that supposedly fed the global liquidity that ultimately “enabled” the current global financial crisis.

Did the Chinese Trade Surpluses Caused the Global Imbalances ?

- ◆ In fact, the Case-Shiller U.S. Home Price Index, which can be taken as a proxy for the speculative asset price inflation caused by the growth of the sub-prime mortgage loans in the U.S., correlates almost perfectly with the U.S. trade deficit with the World but not with the Chinese trade surplus, demonstrating yet once again that the Chinese trade surpluses could not have been responsible for the global imbalances.

Case-Shiller U.S. Home Price Index, Chinese Trade Surplus & U.S. Trade Deficit, Bill. US\$

Case-Shiller Home Price Index (2000Q1=100) , U.S. Trade Deficit and Chinese Trade Surplus

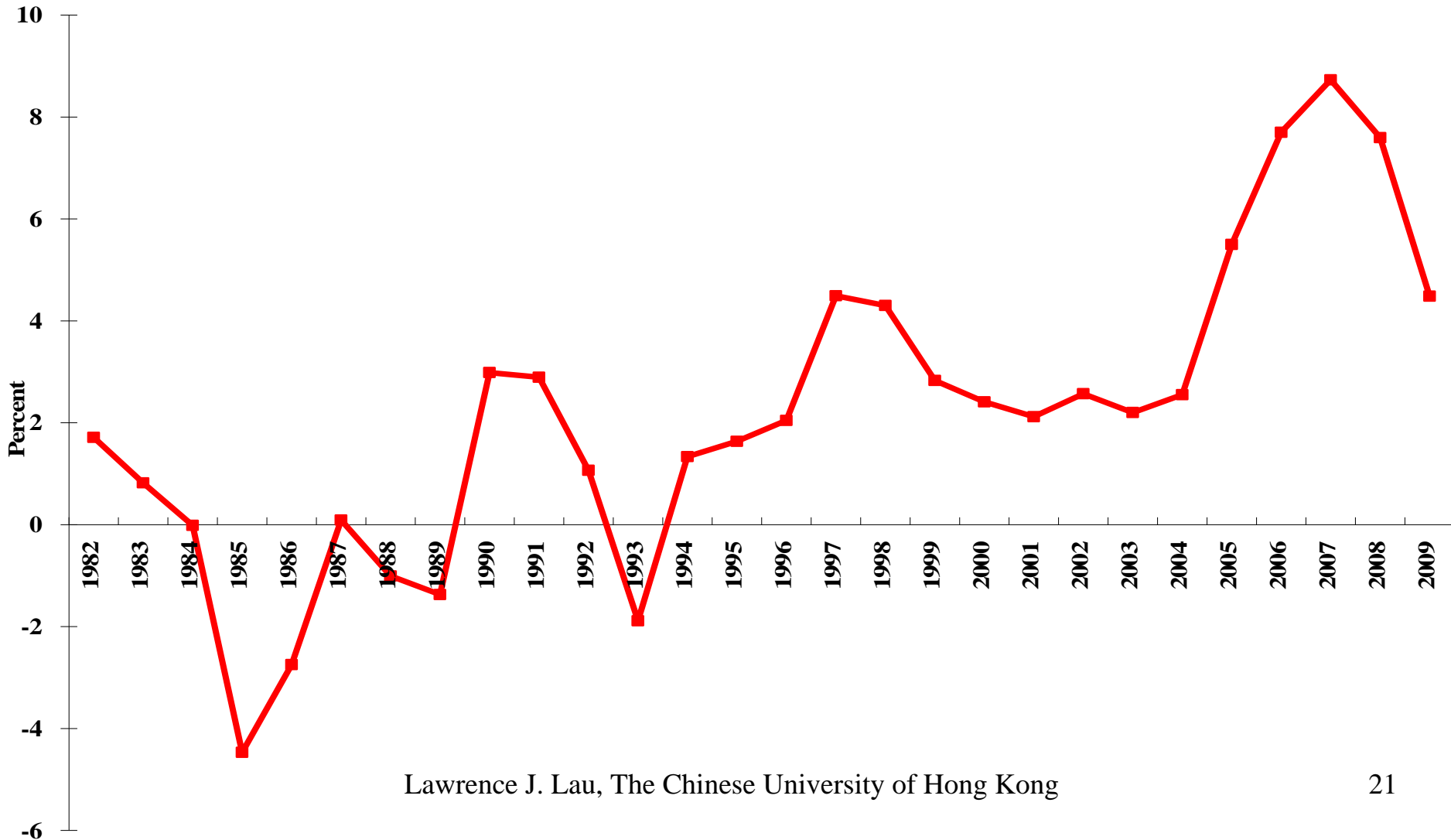


Is Chinese Economic Growth Critically Dependent on Exports?

- ◆ It should be clear from the facts that (1) the Chinese economy has been growing at an average real rate of growth of approximately 10 percent per annum since 1978, and (2) a significant Chinese trade surplus vis-a-vis the World only began to emerge in 2005, that Chinese economic growth could not possibly have been critically dependent on running export surpluses.
- ◆ Chinese trade surplus as a percent of Chinese GDP fluctuated between -4.5 percent and 4.5 percent between 1982 and 2004 with an average of less than 2 percent of GDP. It then rose to almost 9 percent in 2007. It has since declined significantly and is expected to be below 2 percent once again in 2010.

Chinese Trade Balance of Goods and Services as a Percent of GDP, 1982-

Chinese Trade Balance of Goods and Services as a Percent of GDP

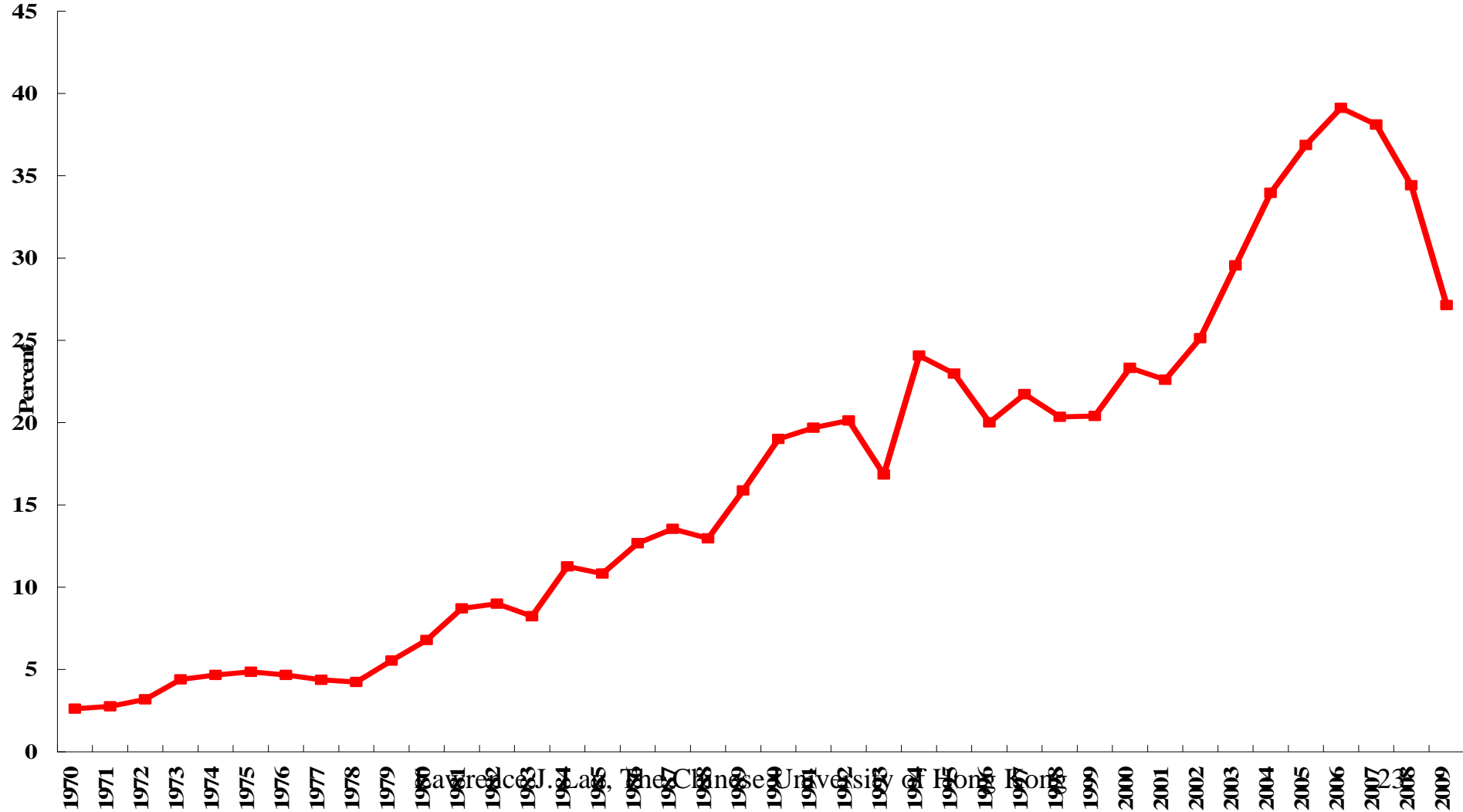


Is Chinese Economic Growth Critically Dependent on Exports?

- ◆ Chinese exports as a ratio of GDP rose steadily beginning in 1978 and reached a peak of almost 40 percent in 2006 and then began to decline to approximately 25 percent in 2009.
- ◆ While this ratio appears large, it is not when compared to Hong Kong, Singapore, South Korea and Taiwan, where exports are more than 100 percent of the respective GDPs.
- ◆ And the Chinese Exports/GDP ratio actually exaggerates the importance of exports in the Chinese economy because it fails to take into account the low domestic value-added content of Chinese exports.

Chinese Exports of Goods and Services as a Ratio of GDP, 1970-present

Chinese Exports of Goods and Services as a Ratio of GDP since 1970



Is Chinese Economic Growth Critically Dependent on Exports?

- ◆ The domestic value-added content of Chinese exports is no more than 30 percent, that is: for every dollar of goods exported, less than 30 cents, on average, consists of domestic value-added. If we multiply the Exports/GDP ratio of say 40 percent (it has actually become much lower recently) to the domestic value-added content of 30 percent, we obtain 12 percent, which is the maximum percentage of Chinese GDP attributable to exports.
- ◆ Now, 12 percent of GDP is a large number, and no economy can afford to lose 12 percent of its GDP overnight. However, if 12 percent of GDP does not grow, or even declines by 25 percent, as long as the other 88 percent of the economy continues to grow, the economy as a whole should do all right, especially if appropriate compensatory economic stimulus measures are taken.

Is Chinese Economic Growth Critically Dependent on Exports?

- ◆ A 25 percent decline in Chinese exports should result in a 25 percent times 12 percent or 3 percent maximum decline in Chinese GDP, other things being equal. Thus, the reduction in exports caused by the global financial crisis should be expected to reduce the Chinese real rate of growth from 9 percent in 2008 to 6 percent in 2009. However, the 4-trillion-Yuan economic stimulus programme launched by the Chinese Government in November 2008 should help make up the short-fall in aggregate demand.

Is Chinese Economic Growth Critically Dependent on Exports?

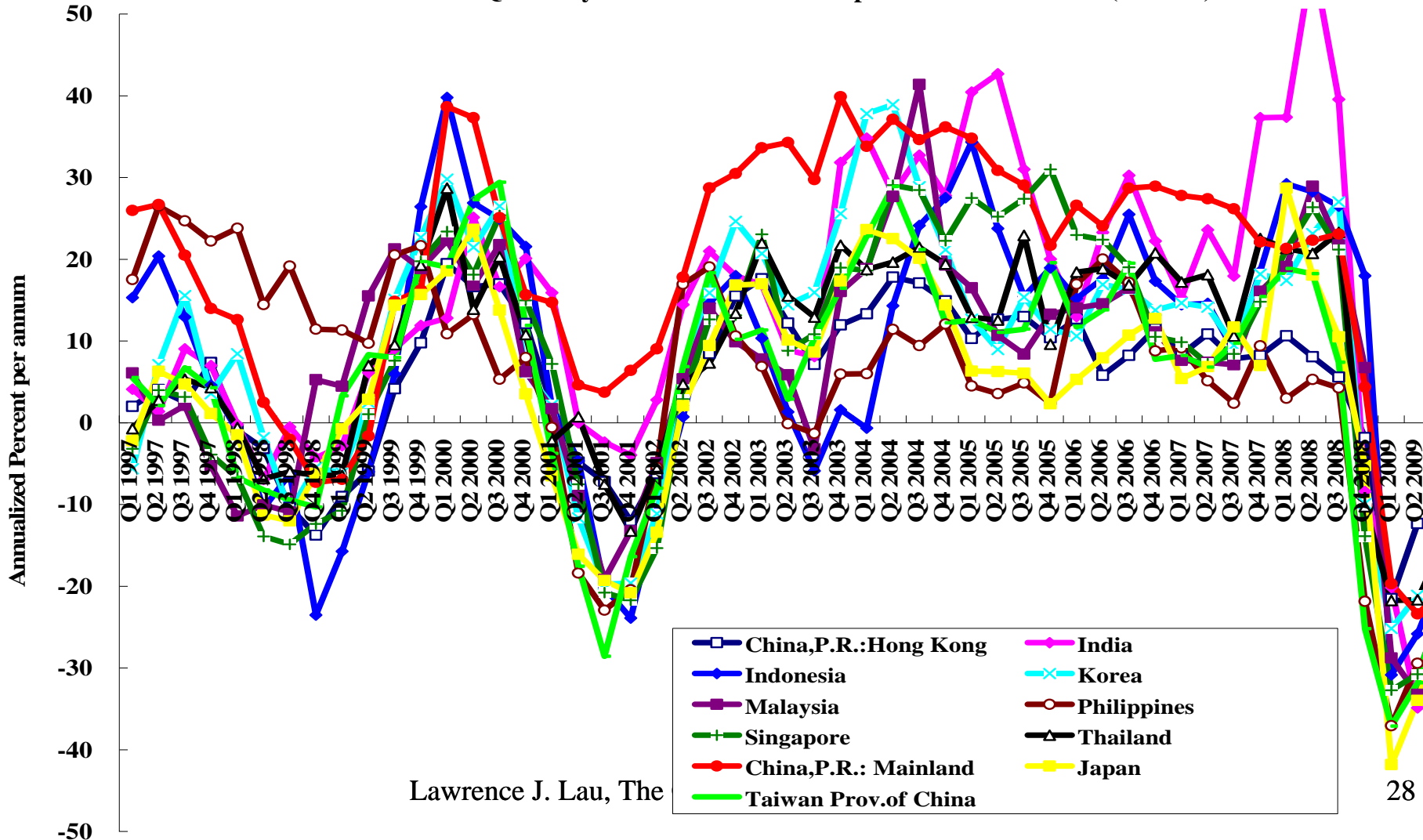
- ◆ Moreover, even if Chinese exports manage to grow by 25 percent per year going forward (which is most unlikely), it will lead to only 3 percent overall economic growth, which is by itself hardly enough. That is why China cannot, and will not, rely on exports as a primary source of its future economic growth.
- ◆ If there were any lingering doubts on the degree of export-dependence of the Chinese economy, they should have been dispelled by the fact that the Chinese economy managed to achieve a real rate of growth of 8.7 percent in 2009, with exports down by 25 percent from 2008 and the U.S. and European economies still mired in recession.

External Dependence of Mainland China

- ◆ An important implication of the relatively low external dependence of Chinese GDP is that the rate of growth of Chinese real GDP is relatively stable even as Chinese exports and imports fluctuate as widely as the exports and imports of other East Asian economies. (see the following charts on the rates of growth of the exports, imports and real GDP of East Asian economies).

Quarterly Rates of Growth of Exports of Goods: Selected East Asian Economies

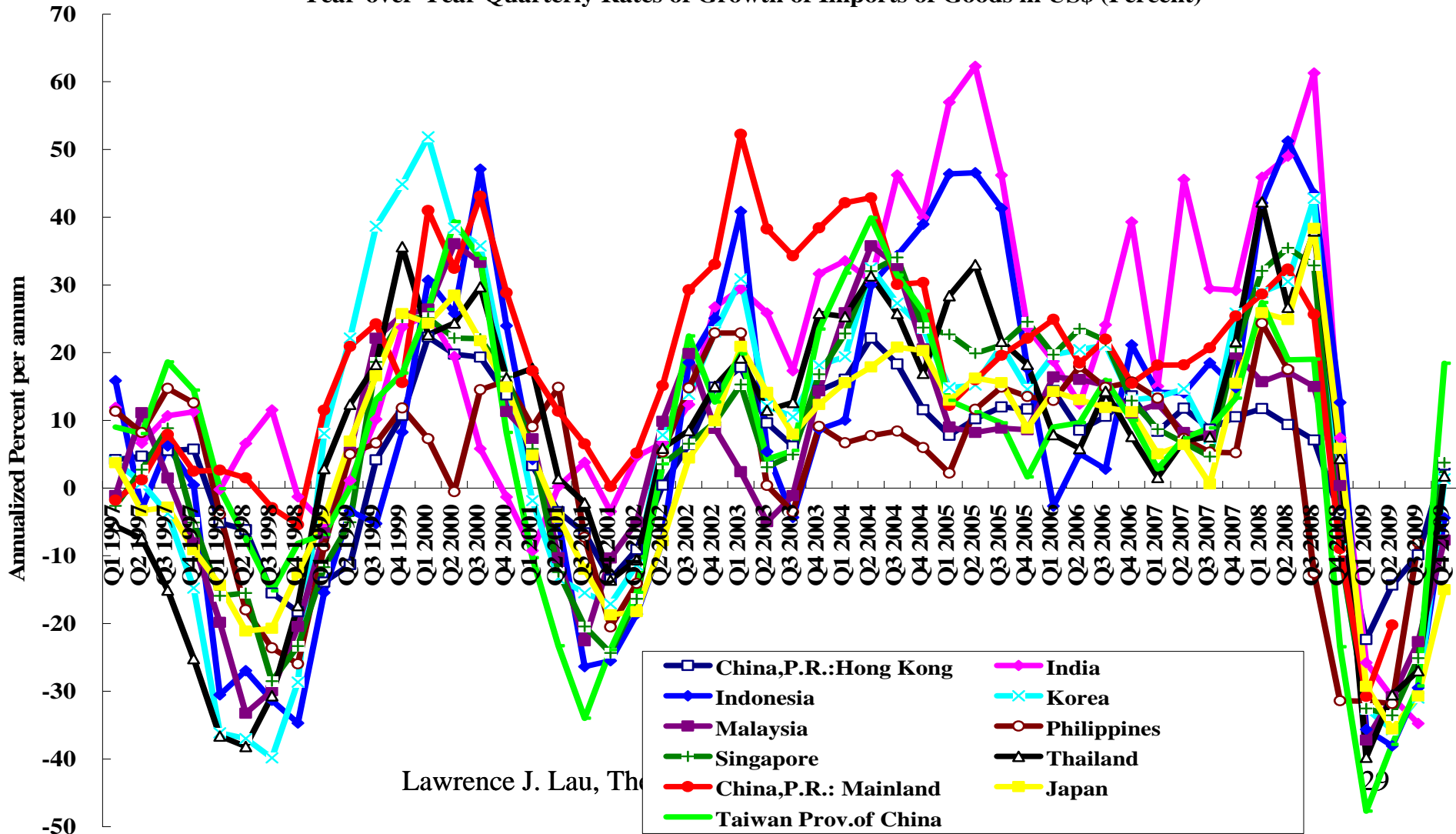
Year-over-Year Quarterly Rates of Growth of Exports of Goods in US\$ (Percent)



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Quarterly Rates of Growth of Imports of Goods: Selected East Asian Economies

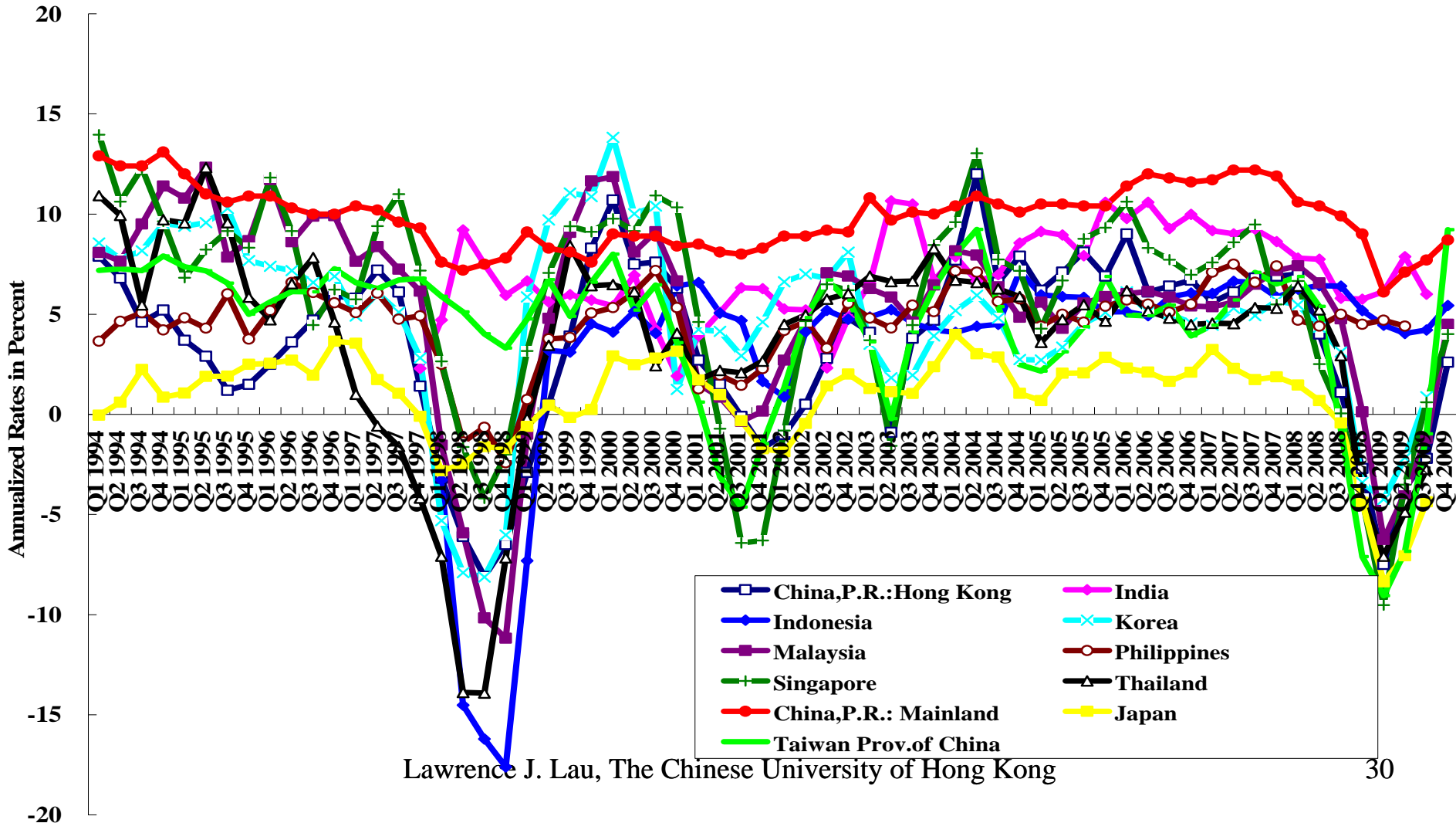
Year-over-Year Quarterly Rates of Growth of Imports of Goods in US\$ (Percent)



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Quarterly Rates of Growth of Real GDP, Y-o-Y: Selected East Asian Economies

Quarterly Rates of Growth of Real GDP, Year-over-Year, Selected East Asian Economies



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Can the Economies of East Asia/China be De-Coupled from the U.S. and Europe?

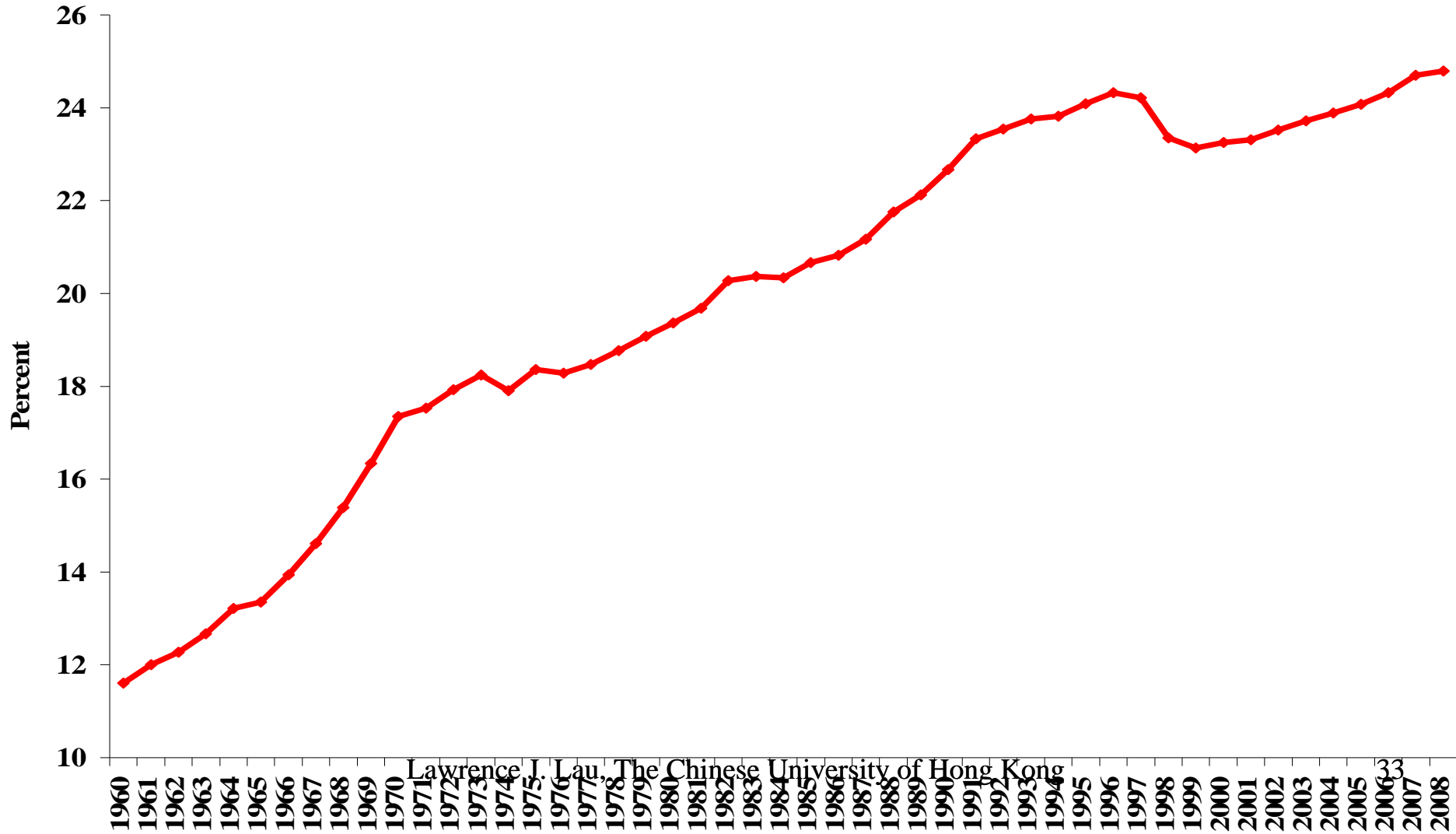
- ◆ East Asia is taken to mean the 10 ASEAN countries (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam) + 3 (China (including Hong Kong, Macao and Taiwan), Japan, and South Korea), that is, approximately, everything east of Bangladesh and west of the Pacific Ocean.
- ◆ The “Partial De-Coupling Hypothesis” says that while East Asia is not immune from the effects of the economic recession in North America and Europe, it can nevertheless continue growing, albeit at somewhat lower rates, even with economic contraction in North America and Europe.
- ◆ Partial de-coupling is a consequence of the economic centre of gravity of the World gradually shifting to East Asia from the United States and Western Europe and within East Asia from Japan to China (but the shifts are not yet completed).

The Shifting Economic Centre of Gravity

- ◆ In the following charts, East Asian and Chinese GDP as percentages of World GDP are respectively presented. Both show very strong trends of growth over the past half a century.
- ◆ In 1960, East Asian GDP, comprising of the GDPs of ASEAN (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam) + 3 (China (Mainland only), Japan, and South Korea) was just over 10 percent of World GDP.
- ◆ Today, East Asian economies account for approximately a quarter of World GDP, comparable to the size of the U.S. economy and that of the Euro Zone.

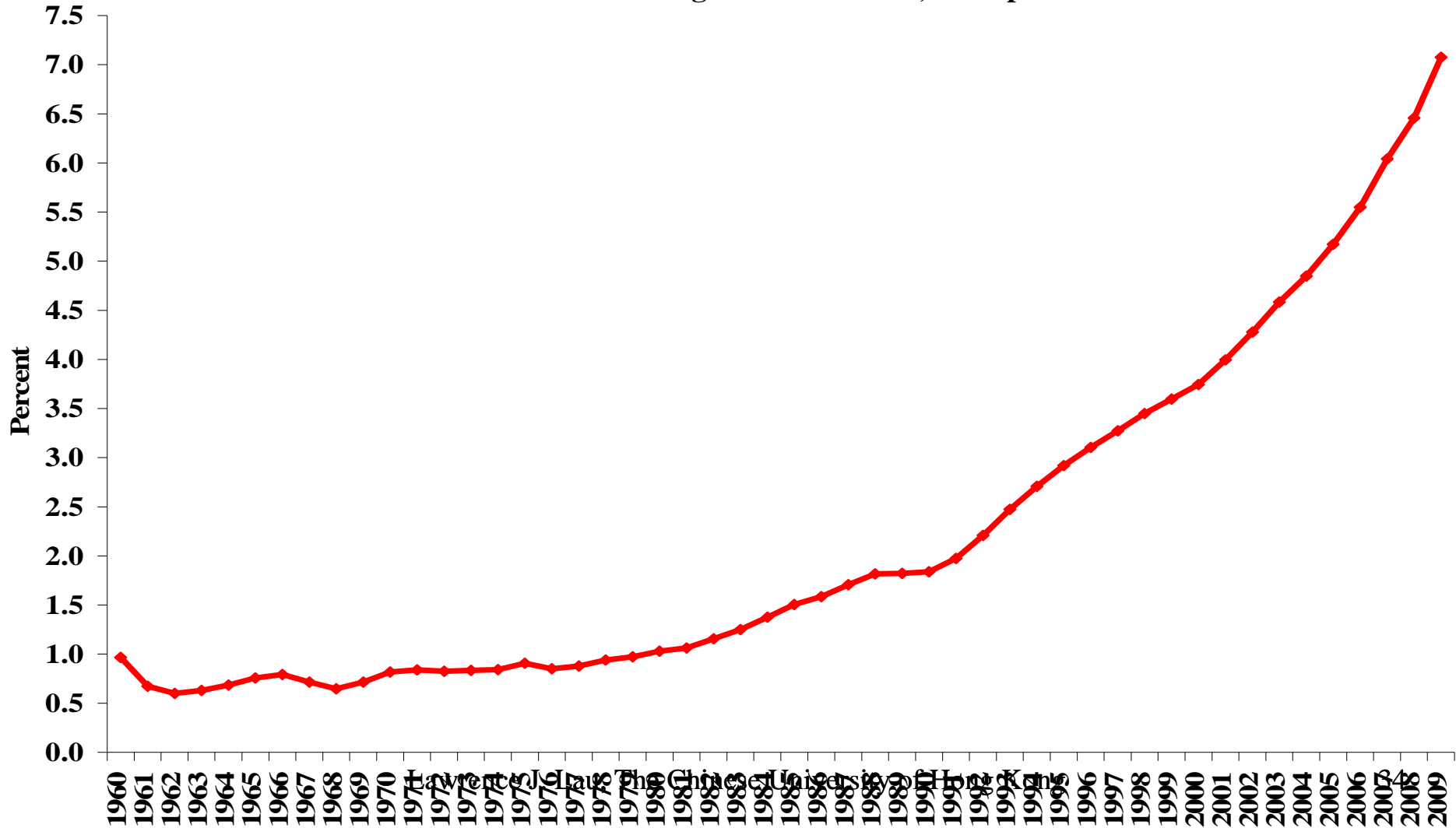
East Asian Share of World GDP, 1960-present

East Asian Share of World GDP, 1960-present



China's Share of World GDP, 1960-present

China's GDP as a Percentage of World GDP, 1960-present

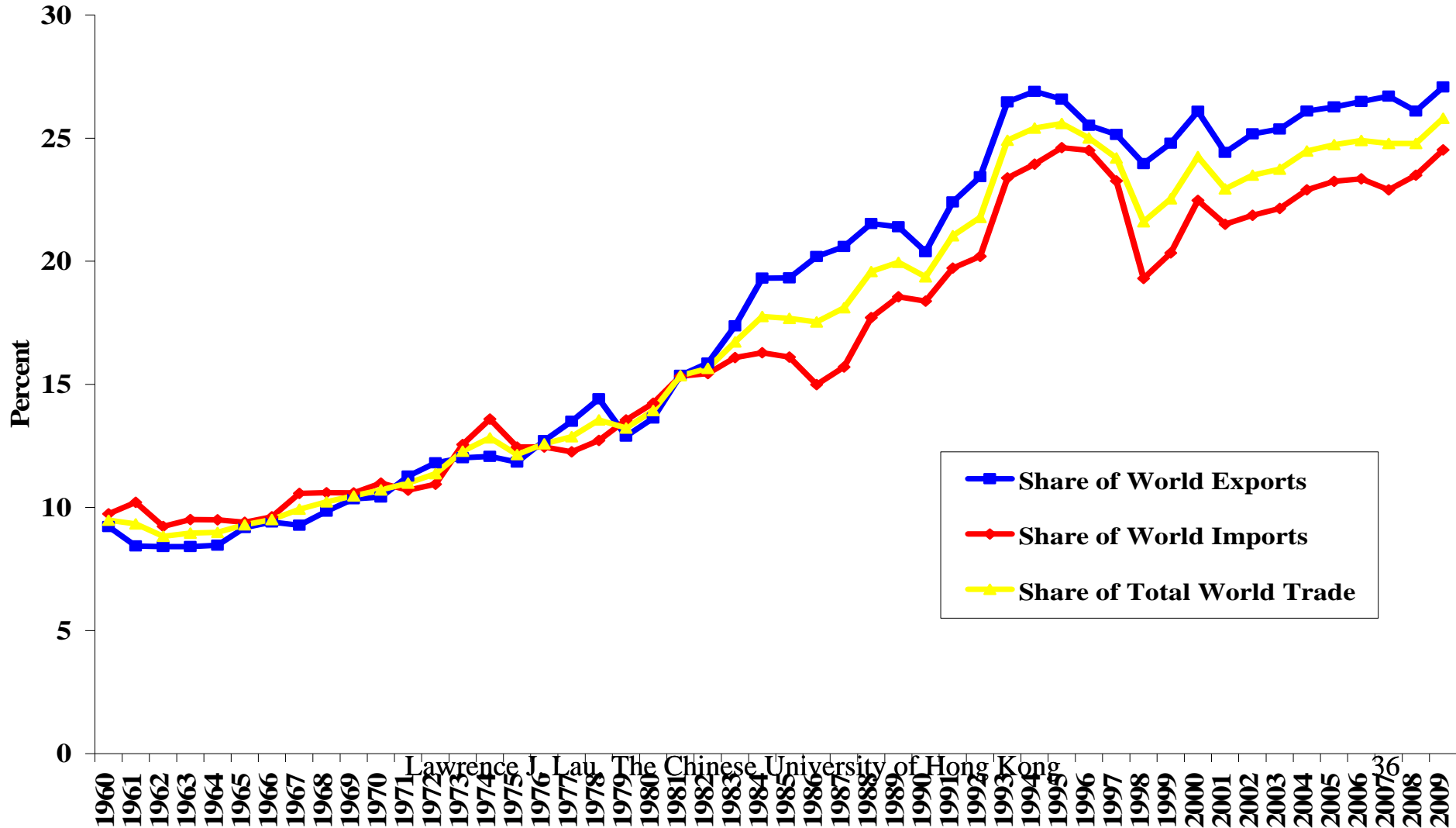


The Shifting Economic Centre of Gravity

- ◆ East Asian shares of World exports, imports, and international trade have also grown from approximately 10 percent in 1960 to a quarter in 2008, paralleling the growth of East Asian share of World GDP (see the following chart).
- ◆ Similarly, Chinese shares of World exports, imports and international trade have also grown from approximately 1 percent of World exports and imports in 1960 to approximately 10 percent of World exports and imports in 2008.
- ◆ China has overtaken Japan to become the largest exporting country in East Asia. China has also overtaken Japan to become the largest importing country in East Asia and the most important export market for almost all East Asian economies and runs trade deficits vis-à-vis almost every one.

The Rising Ratio of East Asian Trade in Total World Trade, 1960-present

East Asian Share of Total World Trade, 1960-present



The Ratio of Chinese Trade in Total World Trade, 1950-present

The Ratio of Chinese Trade to World Trade



Rising Intra-East Asian Interdependence

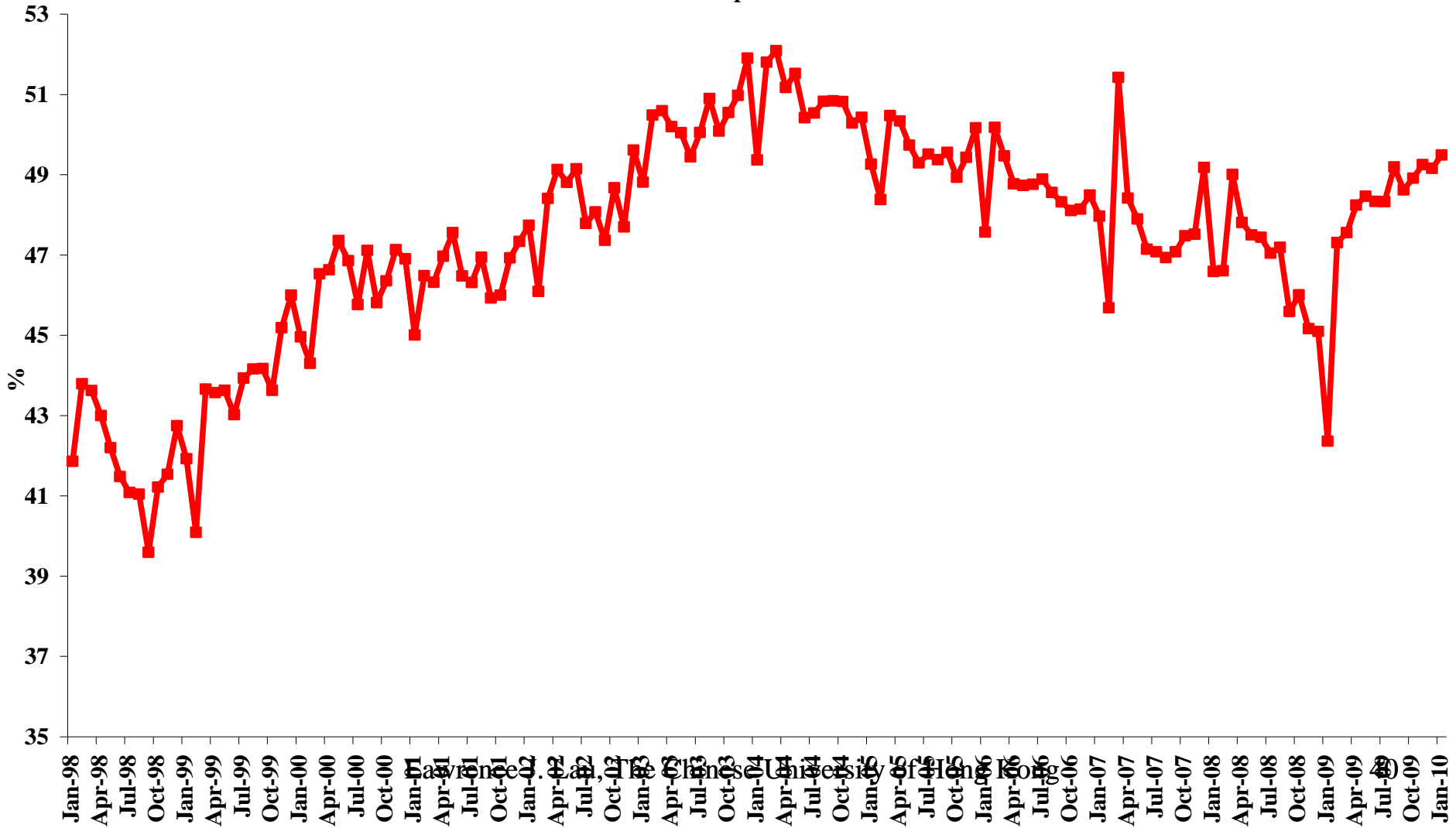
- ◆ The emergence of the Chinese economy on the global market was the one most important new development during the past three decades. Japan has been China's largest trading partner for the past decade and a half and China became Japan's largest source of imports in 2002. The recent pick-up in economic activities in Japan is due in no small parts to the Chinese demand for Japanese exports.
- ◆ Practically every other East Asian economy has a trade surplus vis-à-vis China.

The Shifting Economic Centre of Gravity

- ◆ Because of the rapid economic growth of China and the rest of East Asia outside of Japan, and the demand and supply that such economic growth has generated, the East Asian economies now trade more with one another than with economies outside of East Asia, including the United States. By the late 1990s, approximately half of East Asian trade is among East Asian economies (see the following charts).
- ◆ And while much of the trade consists of raw materials, components, and semi-finished goods which are further processed for exports to developed economies ultimately, much of it has also found itself into the final demands of the domestic markets.
- ◆ This is a sea change compared to say thirty years ago when most of the East Asian trade was between East Asia and the United States and Western Europe and not within East Asia itself.

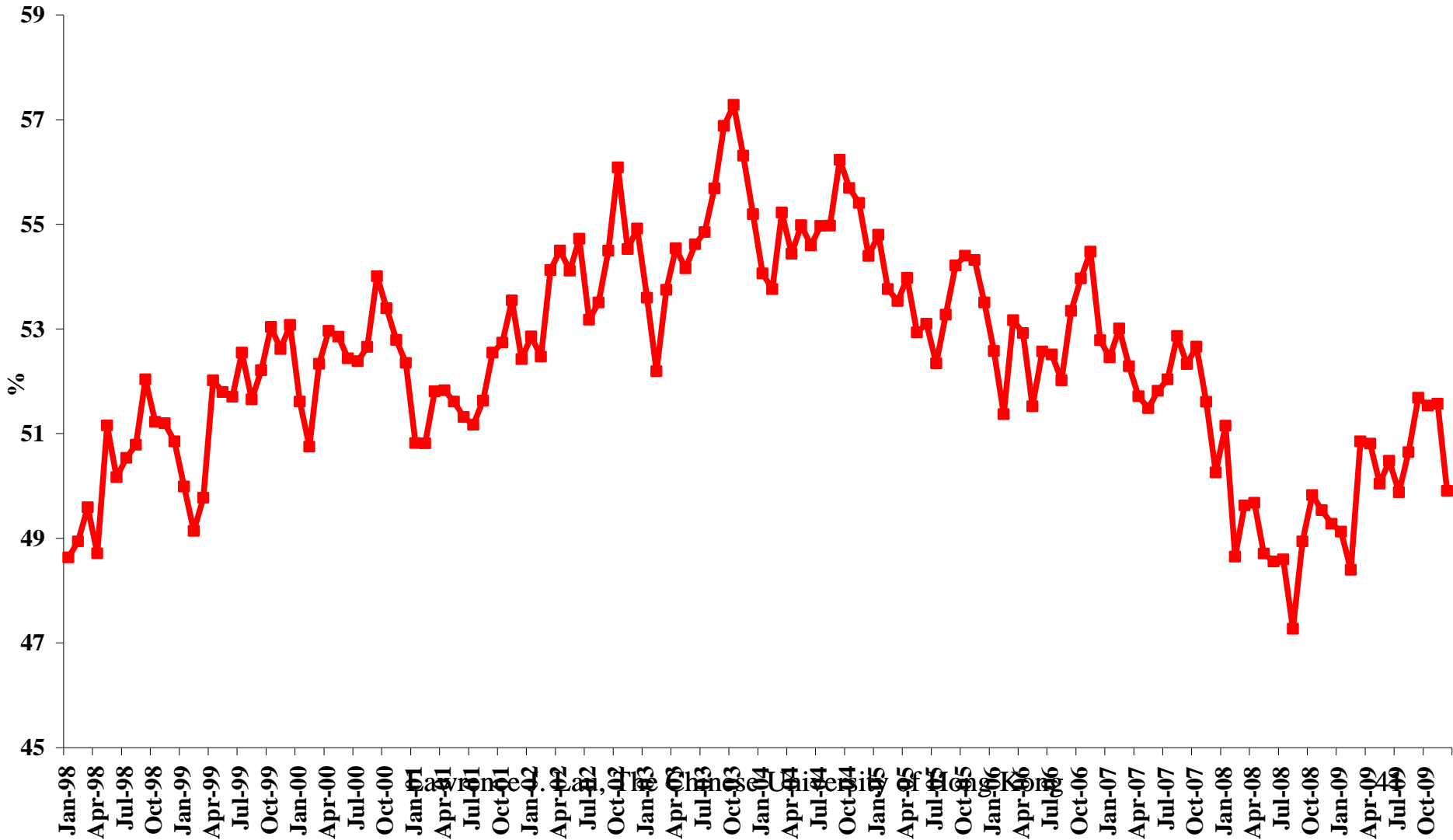
The Share of East Asian Exports Destined for East Asia

The Share of East Asian Exports Destined for East Asia



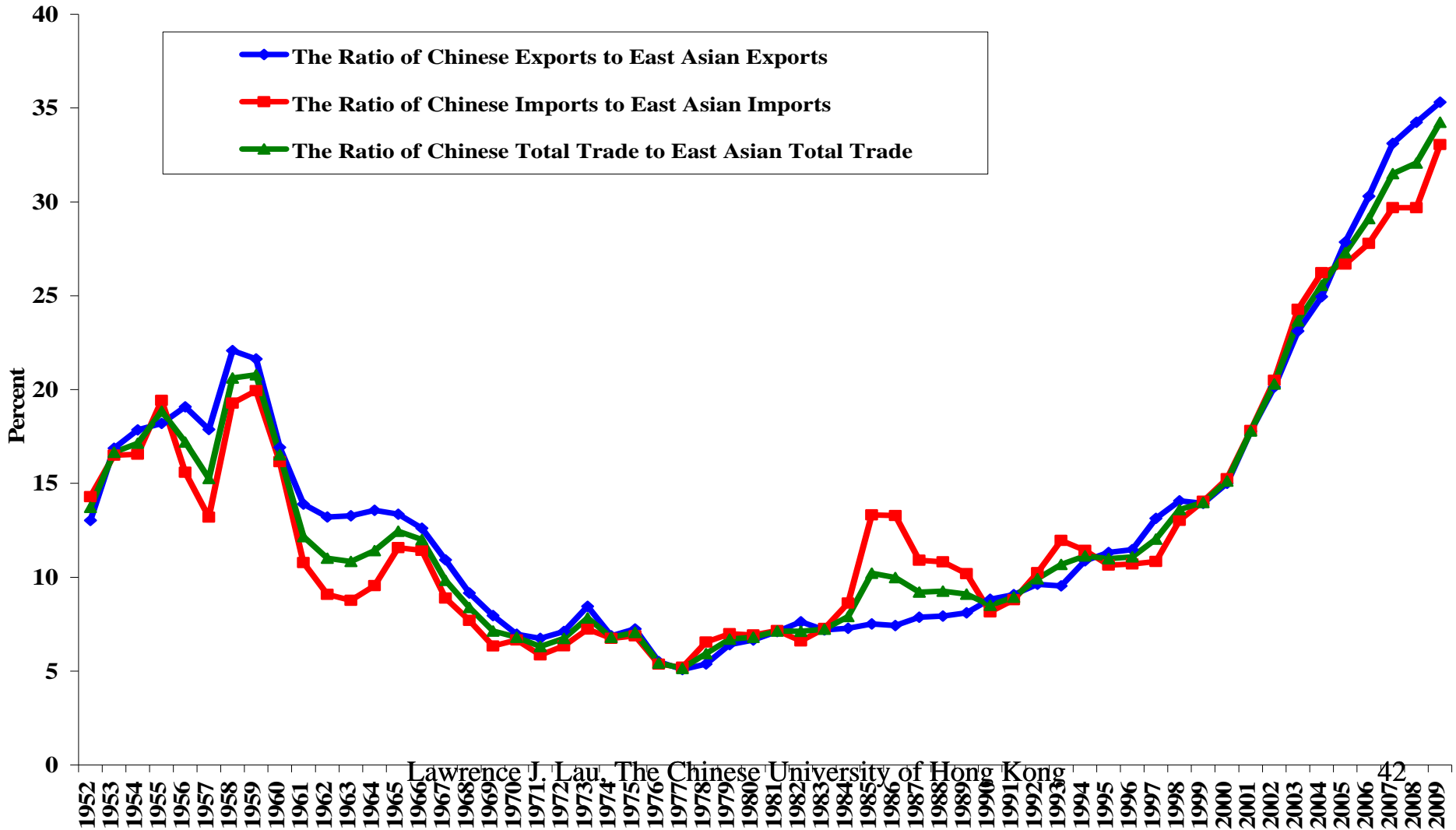
The Share of East Asian Imports Originated from East Asia

The Share of East Asian Imports Originated from East Asia



The Ratio of Chinese Trade in Total East Asian Trade, 1952-present

The Ratio of Chinese Trade to East Asian Trade



Can the Economies of East Asia/China be De-Coupled from the U.S. and Europe?

- ◆ Given the current trends in rates of economic growth, East Asia will surpass the United States in terms of aggregate GDP with China perhaps contributing the highest proportion of the total by 2015.
- ◆ This is what gives credence to the idea of partial “de-coupling” of the World economies—that the Chinese and East Asian economies can continue to do reasonably well despite the current economic problems in the U.S. and elsewhere.
- ◆ However, China, with its GDP accounting for only 7% of the World total, and East Asia are not large enough to turn around the whole World. The talk about G-2 is premature.

Potential Sources of Sustainable Growth of Aggregate Demand

- ◆ Chinese economic growth beyond 2010 will have to depend mostly on internal demand and not on exports.
- ◆ The possible sectors, in addition to public infrastructural investment, include:
 - ◆ (1) Owner-occupied residential housing
 - ◆ (2) Education and Health Care and the introduction of high technology
 - ◆ (3) Acceleration of urbanization and construction of mass transit systems
 - ◆ (4) Conservation of energy, environmental protection and preservation, and promotion of the green economy

The Owner-Occupied Residential Housing Sector

- ◆ One important source of sustainable aggregate demand is owner-occupied residential housing. Despite significant development of residential housing during the past thirty years, there is still a great deal of room to grow, especially in the interior provinces and regions and for the middle-to-lower-middle income households.
- ◆ Owner-occupied residential housing has been a major engine of growth for many countries and regions for decades during their periods of fastest economic growth. There is no question that there is a huge potential demand here in China.
- ◆ The demand for residential housing also generates with it the derivative demands for furniture, refrigerators, washing machines, television sets, curtains, carpets, household goods and services and with them a great deal of employment and activities for small and medium enterprises. It will generate demand for many products that face a sharply reduced export demand. It will help these enterprises to reorient themselves to serve the domestic market.

The Owner-Occupied Residential Housing Sector

- ◆ Two measures will greatly increase the demand for owner-occupied residential housing. First, longer-term, say thirty-five years, owner-occupied residential mortgage loans meeting certain criteria should be promoted. Second, fixed-rate mortgage loans should be offered for the duration of the loan period. These two measures will make residential housing ownership affordable (through the large reductions in the required monthly payments) and safe (through the fixed-rate feature reducing the risks of a variable interest rate) to a large majority of the middle- and lower-income households.

The Owner-Occupied Residential Housing Sector

- ◆ Long-term fixed rate mortgage loans made by commercial banks can be “toxic” because they do not have long-term fixed rate deposits and can easily get into trouble when the interest rate on short-term deposits rise. Thus a state policy bank, say, China Home Loan Bank, can be established to issue long-term fixed-rate bonds (potential purchasers are insurance companies and pension funds which have long-term funds and do not need the liquidity) and with the proceeds purchase qualified mortgage loans from the commercial banks.
- ◆ It is even possible for the rate of interest on such mortgage loans to be lowered since the state policy bank does not need such a large interest rate spread.
- ◆ In order that the market for residential housing, and hence the market for mortgage loans, functions properly, the rights of the home-owner owning the property and the rights of the lender, in the event of a loan default, must be protected.

The Education and Health Care Sectors

- ◆ This is the time to increase support for the education sector across the board—primary, secondary and tertiary and for the health care sector, extending the accessibility and availability in the rural areas.
- ◆ Both the physical structures as well as the human resources of primary and secondary schools and of hospitals need to be upgraded.
- ◆ In addition, China should adopt a policy of assuring low-cost or no-cost access to the internet by all students in China everywhere, all the way down to the primary school level. Promoting and making universal the laptop is one way to achieve this goal. Many Chinese households are able to afford laptop computers—the difficulty is having inexpensive and ready access to the internet.
- ◆ Public health and preventive medicine should be widely promoted. Food and drug safety should be a top priority and high technology can be applied to testing and certification

The Education and Health Care Sectors

- ◆ Making the internet accessible everywhere in China will greatly narrow the inequality of education (and information) between the urban and rural areas and reduce the so-called digital divide between the rich and the poor. It will be a great equaliser, because, for example, large and small enterprises will compete more or less equally on the internet.
- ◆ This will also create a great deal of domestic demand for the high-technology sector which faces a sharp and possibly long-term decline in their export markets.

Urbanization and Mass-Transit Systems

- ◆ Urbanization should be accelerated, but instead of making the existing cities larger and more crowded, new cities should be built in the rural areas, bringing capital and technology to labour rather than the other way around.
- ◆ Urbanization in the rural areas is possible only if the rural households currently with using their land can have their property rights recognized and made transferable.
- ◆ The inter-urban communication and transportation infrastructure needs to be further planned and improved, especially in the building of new cities. Super-high-speed trains should be promoted as the preferred mode of transportation between major cities.
- ◆ Central planning of new cities, with regard to their locations, layouts, land use, densities, and intra-urban communication and transportation infrastructure, is required.

Urbanization and Mass-Transit Systems

- ◆ Mass-transit systems should be the principal means of intra-urban transportation for existing as well as new cities, and this also requires planning, preferably from the very beginning, and cannot be left to the market.
- ◆ With at least a couple of hundreds of Chinese cities say over 2 million in population and requiring mass-transit systems, the planning, designing, building and operating mass-transit systems can be a huge new industry with significant domestic and eventually export demand.
- ◆ In order to economise on the use of the scarce land resource, and to assure the efficiency and environmental friendliness of the urban transportation system, high density land use should be mandated in the cities.

Environmental Protection and Green Technologies

- ◆ Green technologies can find significant application in the residential housing sector—in terms of heating, cooling, lighting, provision of hot water, etc.
- ◆ The mass-transit systems provide an indispensable alternative to the use of the automobile. “A car in every garage” would be a nightmare for China and for the world. Urban residents should not require the use of an automobile in their everyday life.
- ◆ China has an advantage in introducing technologies for green or greener vehicles because it has relatively little sunk costs. China also has a substantial incentive in developing clean coal technologies, having large coal reserves itself.
- ◆ It can also introduce and promote alternative sources of energy, such as solar power and wind power based on its own huge internal demand.

Concluding Remarks

- ◆ There is no empirical evidence that the Renminbi (Yuan) is under-valued today. If China is able to maintain an approximate balance of trade in goods and services combined under conditions of free trade (WTO conditions), its exchange rate is neither under-valued nor over-valued.
- ◆ Chinese economic growth will be marginally, but not critically, affected by a large decline in its exports, as demonstrated by its experience in the past couple of years as well as during the 1997-1998 East Asian currency crisis. Thus, it will be able to survive financial crises in the European and U.S. economies.
- ◆ The long-term sustainable sources of Chinese aggregate demand will be internal: investment in infrastructure, owner-occupied residential housing, investment in education and health care, urbanisation (building new cities), urban mass-transit systems and high-speed inter-urban trains, environmental protection and preservation, energy conservation and renewable energy, and the green economy.