The New Era in China: An Economist's View

Lawrence J. Lau 刘遵义
Ralph and Claire Landau Professor of Economics, The Chinese Univ. of Hong Kong
and
Kwoh-Ting Li Professor in Economic Development, Emeritus, Stanford University

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Tel: +852 3943 1611; Fax: +852 2603 5230
Email: lawrence@lawrencejlau.hk; WebPages: www.igef.cuhk.edu.hk/ljl

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Introduction:
The New Era

- What is the meaning of "the New Era"? The new era refers specifically to present-day China.
- Three distinct eras may be distinguished in the People's Republic of China since its establishment in 1949:
- (1) 1949-1978, the MAO Era—the establishment and consolidation of the People's Republic of China;
- (2) 1979-2012, the DENG Era—the economic reform and opening to the world;
- (3) 2013-, the XI Era—from a moderately prosperous to a wealthy and strong nation.
- China is now already the second largest economy in the world. At its current average annual rate of growth of approximately 6.5%, it is expected to catch up and overtake the U.S. to become the world's largest economy some time before 2035. Nevertheless, even then, Chinese GDP per capita, at a projected US$20,000 in 2017 prices, will still be less than one-quarter of the projected U.S. GDP per capita.

Introduction:
The Tasks in the New Era

- In the new era, the Chinese Government will undertake to **deepen reform**, **widen opening**, and **enhance quality**. It is also expected to **share prosperity** and **reduce risks** to the economy.
- The DENG Era is one in which some of the people would become wealthy first. In the XI era all people will become wealthy together.
- In the Thirteenth Five-Year (2016-2020) Plan, the only mandatory targets have to do with the preservation, protection and restoration of the environment and the alleviation and elimination of poverty.
- In the XI era, the economic policies will be people-centric. A modern socialist market economy will be established under the leadership and stewardship of the Communist Party of China.

Introduction:
Review of the Economy in 2017

- The rate of growth of real GDP was 6.9%, the first year-on-year increase since 2011. (The rate of growth of real GDP in 2018Q1 was 6.8%). This signals the end of the vertical part and the arrival at the horizontal part of the L-shaped recovery.
- The rate of growth of the consumer price index (CPI) was 1.6% compared to 2% in 2016. The producer price index (PPI) increased by 6.3%.
- Employment increased by more than 13 million. The urban unemployment rate at year-end was 4.98%.
- The disposable income per capita increased by 7.3%, higher than the rate of growth of real GDP and real GDP per capita.
- The Renminbi exchange rate has remained stable. The official foreign exchange reserves remained at US$3.14 trillion at year-end 2017, equivalent to almost one and a half year worth of annual imports (US$2.21 trillion in 2017).
- The energy per unit of real GDP declined by 3.7%, indicating an improvement in the quality of growth. The capacity utilization rate in industry rose to 77%, reflecting the progress in the supply side structural reform and the reduction of excess production capacities.

Deepen Reform

- The most important reform is the supply side structural reform, aimed at the prevention of new and reduction of old excess production capacities in many industries (steel, cement, plate glass, aluminum, ship-building, solar panels, coal mining) and the rationalization of the so-called "zombie enterprises".
- It is also aimed at letting the market play the decisive role. However, this requires changes in the key performance indicators of local party and government officials. It requires cooperation and collaboration across local governments. It also requires the central government to step up to prevent protectionism at the local level vigorously. In principle, Chinese local governments cannot impose any restrictions on the inflow and outflow of goods and services. In practice they use their power to issue permits to practice de facto local protectionism, which is totally illegal according to Chinese law.
- The central government must also formulate, enact and use anti-trust laws to intervene to prevent monopolistic or oligopolistic practices and keep the markets competitive if the market is to play the decisive role.

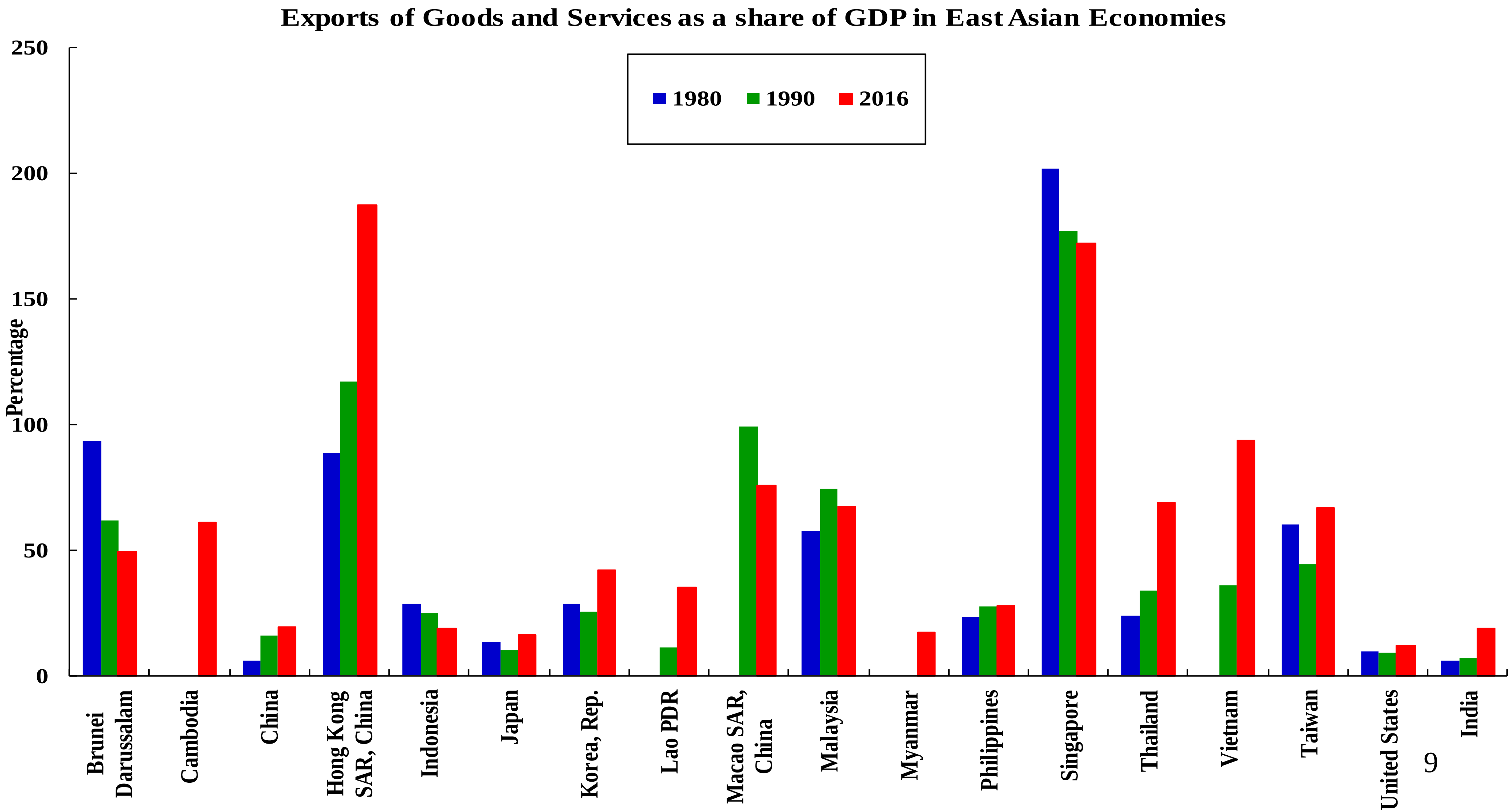
Widen Opening

- China was a major beneficiary of economic globalization. More than 600 million Chinese people have been lifted up from poverty through Chinese economic reform and opening up since 1978.
- China is already the most important trading partner of many countries and regions. However, Chinese exports is now only a relatively small percentage, less than 15 percent, of Chinese GDP, similar to other large economies such as the U.S. and Japan.
- Chinese history indicated that the closing of the borders in the Ming and Qing Dynasties was in retrospect a huge mistake. China failed to take advantage of its then comparative advantage. (Of course, the forced imports of opium by the British in the 19th Century was another issue.) Japan's opening to the world since the Meiji Restoration of 1868 enabled the development of Japan into a modern nation. China was left far behind. Isolationism and protectionism have repeatedly proved to be failed ideas.

The Ranks of China as Trading Partner of Asia-Pacific Countries/Regions and Vice Versa, 2016

Country/Region	Chinese Rank as Trading Partner of Country/Region	Rank of Country/Region as Trading Partner of China
Australia	1	9
Brunei	5	128
Cambodia	1	71
Hong Kong	1	4
Indonesia	1	19
Japan	1	5
Korea	1	6
Laos	2	89
Macau	1	80
Malaysia	1	11
Myanmar	1	42
New Zealand	1	45
Philippines	1	21
Singapore	1	14
Taiwan	1	7
Thailand	1	12
United Kindom	3	13
United States	1	1
Vietnam	1	10

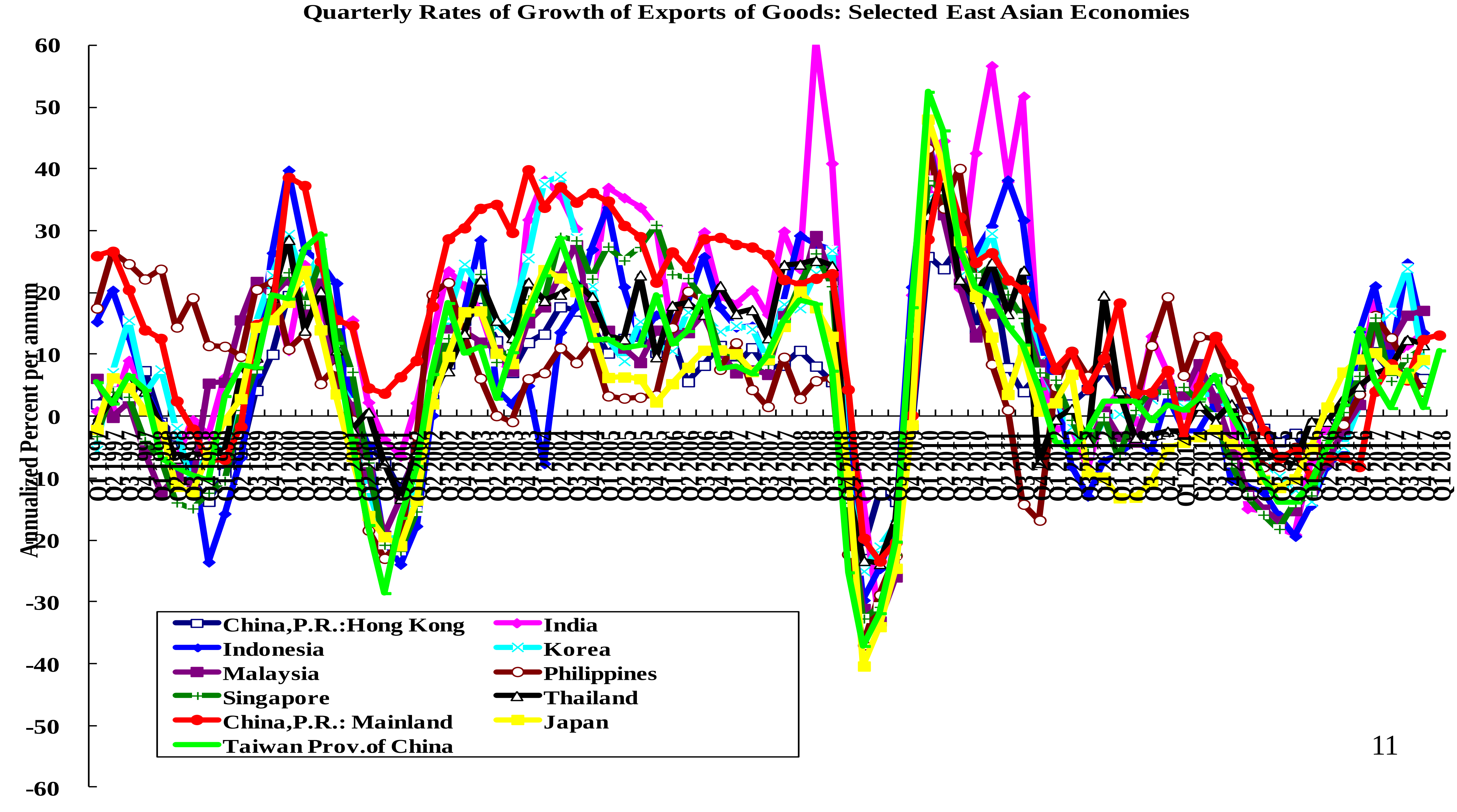
Exports of Goods and Services as a Share of GDP in East Asian Economies, India & U.S.



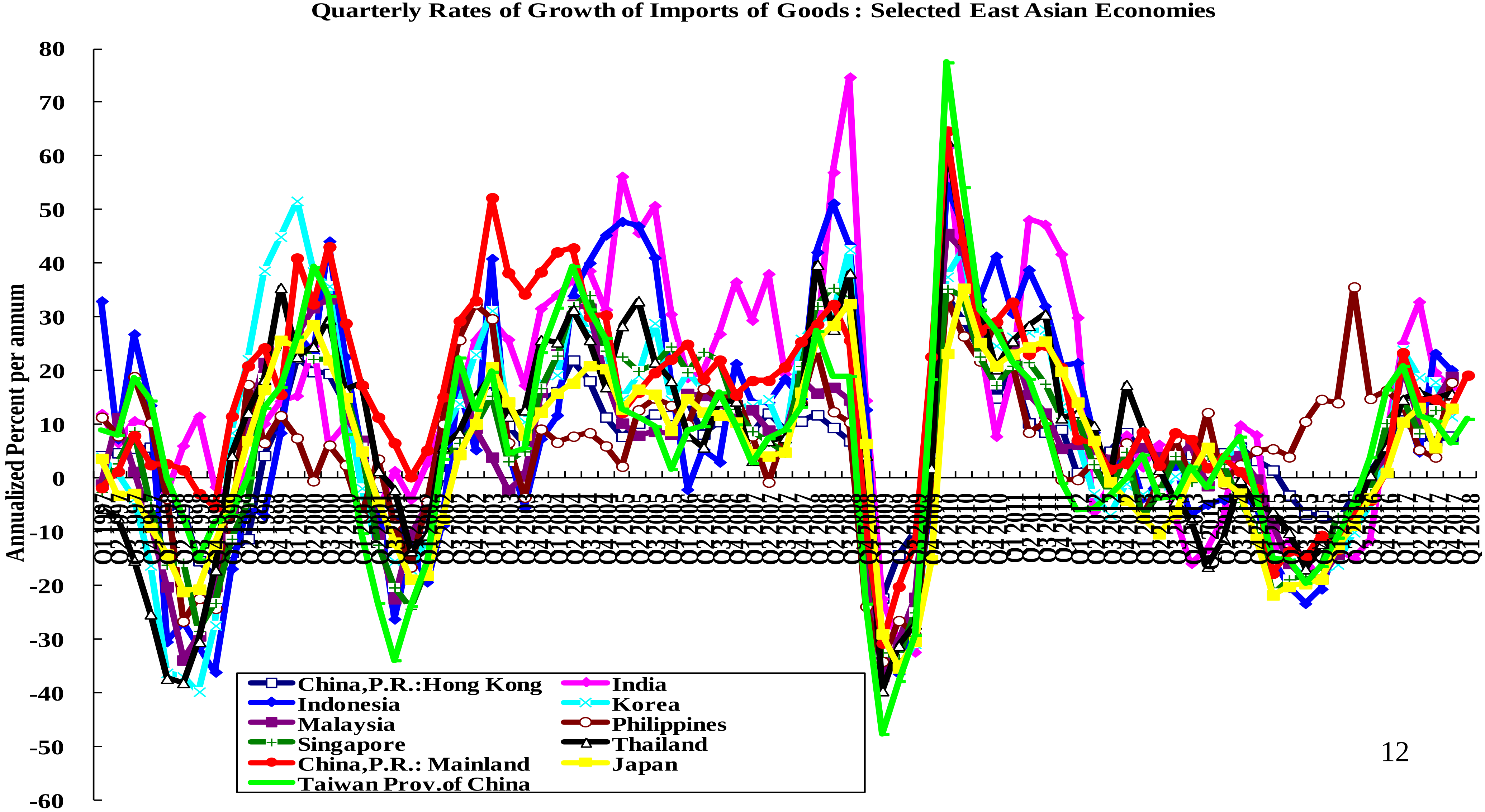
Widen Opening

- Opening wider serves Chinese interests. China continues to have substantial excess national savings. China wishes to continue to benefit from technology transfer, which begins to be more two-way. Competition from foreign firms can exert pressure on Chinese enterprises in Chinese markets and help to prevent the emergence of monopolies and quasi-monopolies, thus making Chinese enterprises more efficient, more quality-conscious, and more competitive.
- However, China, like all other large economies, can readily survive on its own if necessary. The experience since the Global Financial Crisis of 2007-2008 clearly demonstrated that this was indeed the case with the partial decoupling of the economies of East Asia from those of North America and Western Europe (see the following charts).

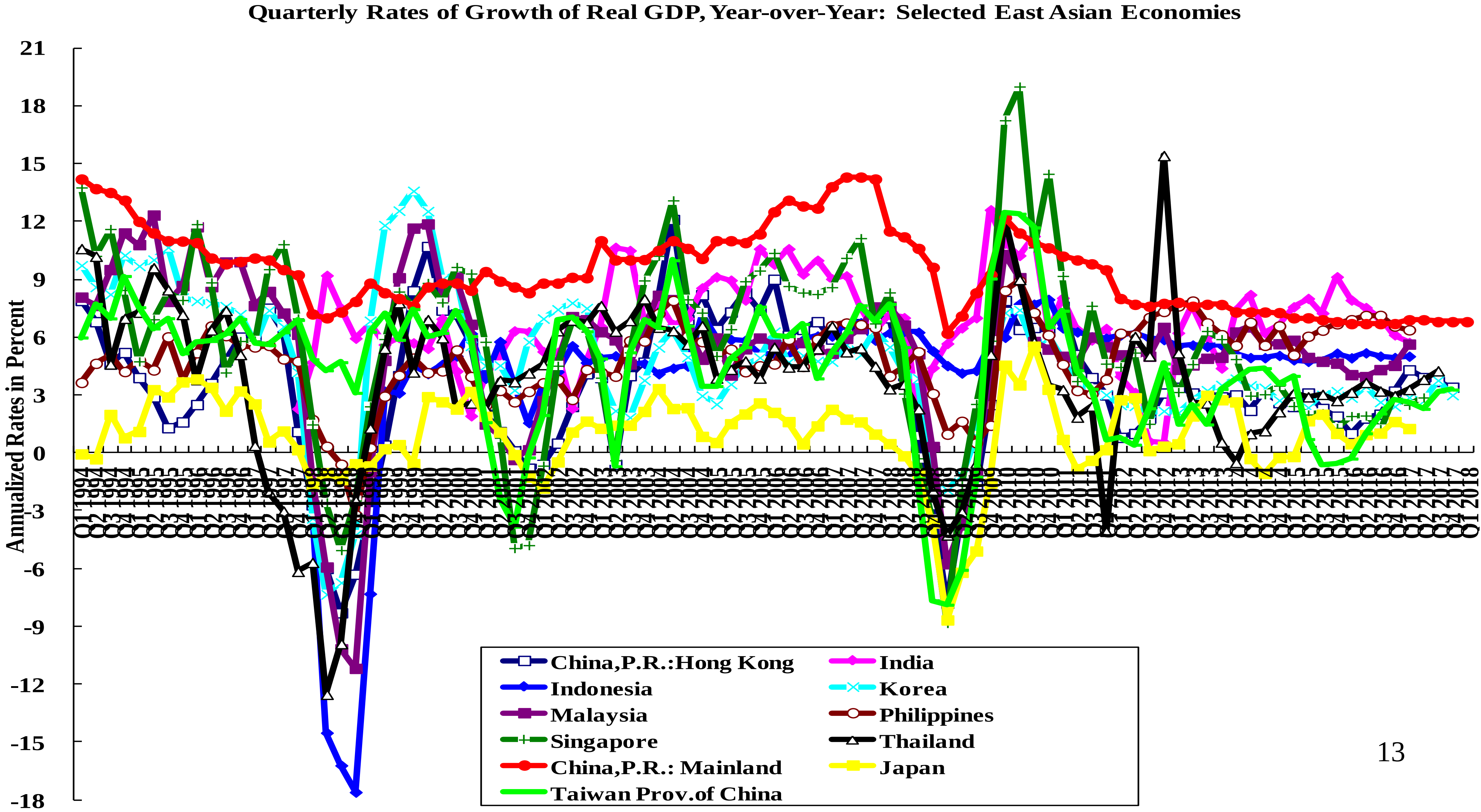
Quarterly Rates of Growth of Exports of Goods: Selected Asian Economies



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



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



Widen Opening

- China will expand imports and reduce tariffs (e.g., on automobiles). Customs revenue is already a very small percentage of the total revenue of the central government. Many Chinese manufacturing enterprises are among the world's largest. They are no longer "infants" that need protection from imports.
- China will liberalize the rules for foreign direct investment and improve the investment environment, including allowing wholly owned foreign enterprises in both financial and manufacturing sectors (e.g., insurance, securities brokerage, and automobile manufacturing). This will make the complaints about "forced technology transfer" moot. Foreign direct investors no longer need to take a local partner if they do not wish to do so.
- China has already greatly improved the protection of intellectual property through its establishment of special intellectual property courts that have nation-wide jurisdiction. These efforts will continue as China has also become an inventive nation itself.

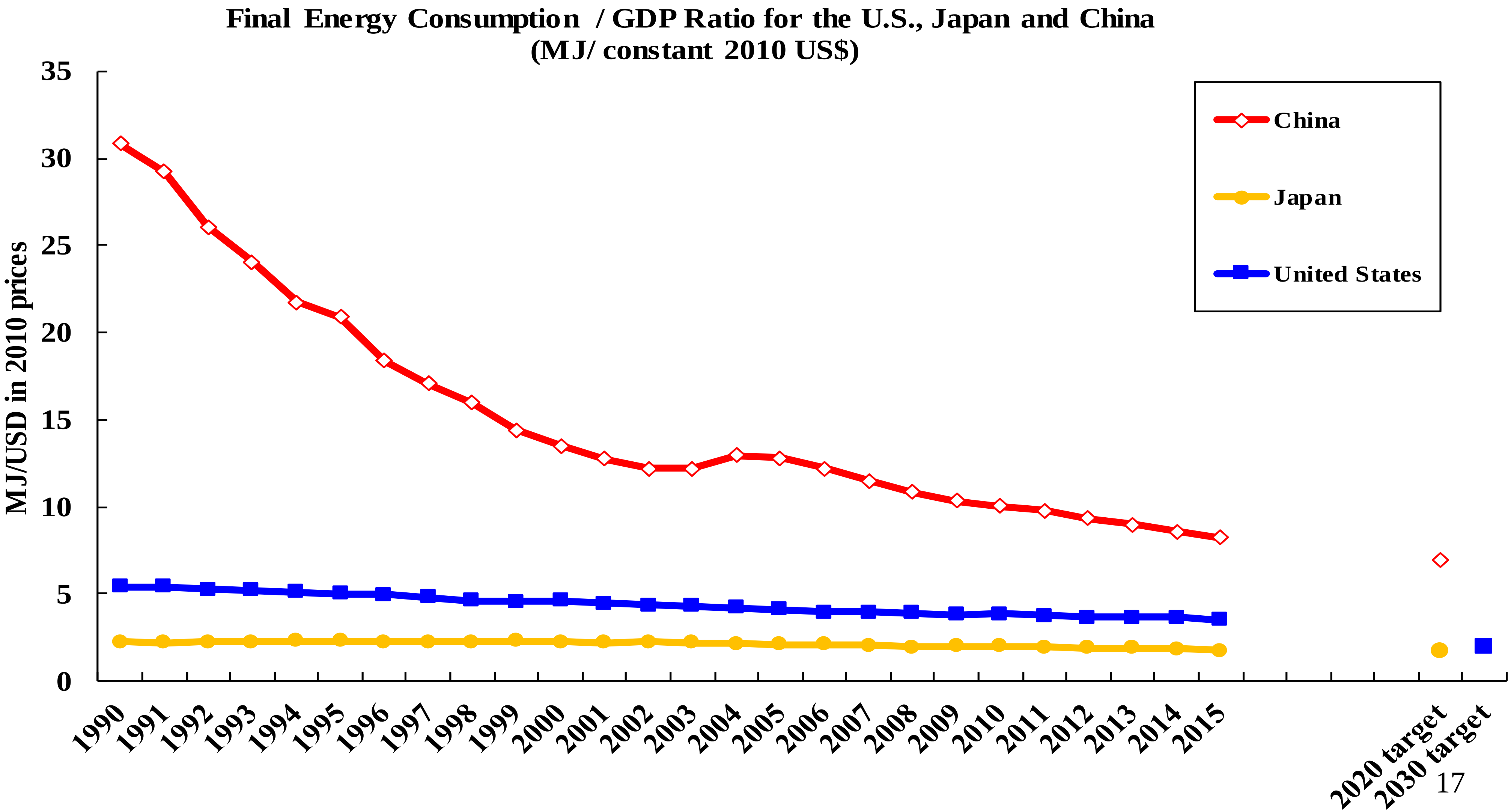
Enhance Quality

- The focus going forward will be on the quality of growth rather than the quantity of growth. This means:
- Growth with an emphasis on environmental protection, preservation and restoration—green mountains, blue skies and clear waters;
- Growth that is innovation-driven instead of input-driven;
- More competitive markets through the regulation of monopolies and quasi-monopolies and the use of anti-trust laws;
- Growth with an emphasis on food and drug safety;
- Growth with a more equitable distribution (and redistribution) of income—alleviation of poverty and public goods consumption (including education, health care and elderly care, in addition to the environment) and reform of the wage determination mechanism;
- Providing a permanent solution to the problem of the status of long-term migrant workers (revision of household registration rules).

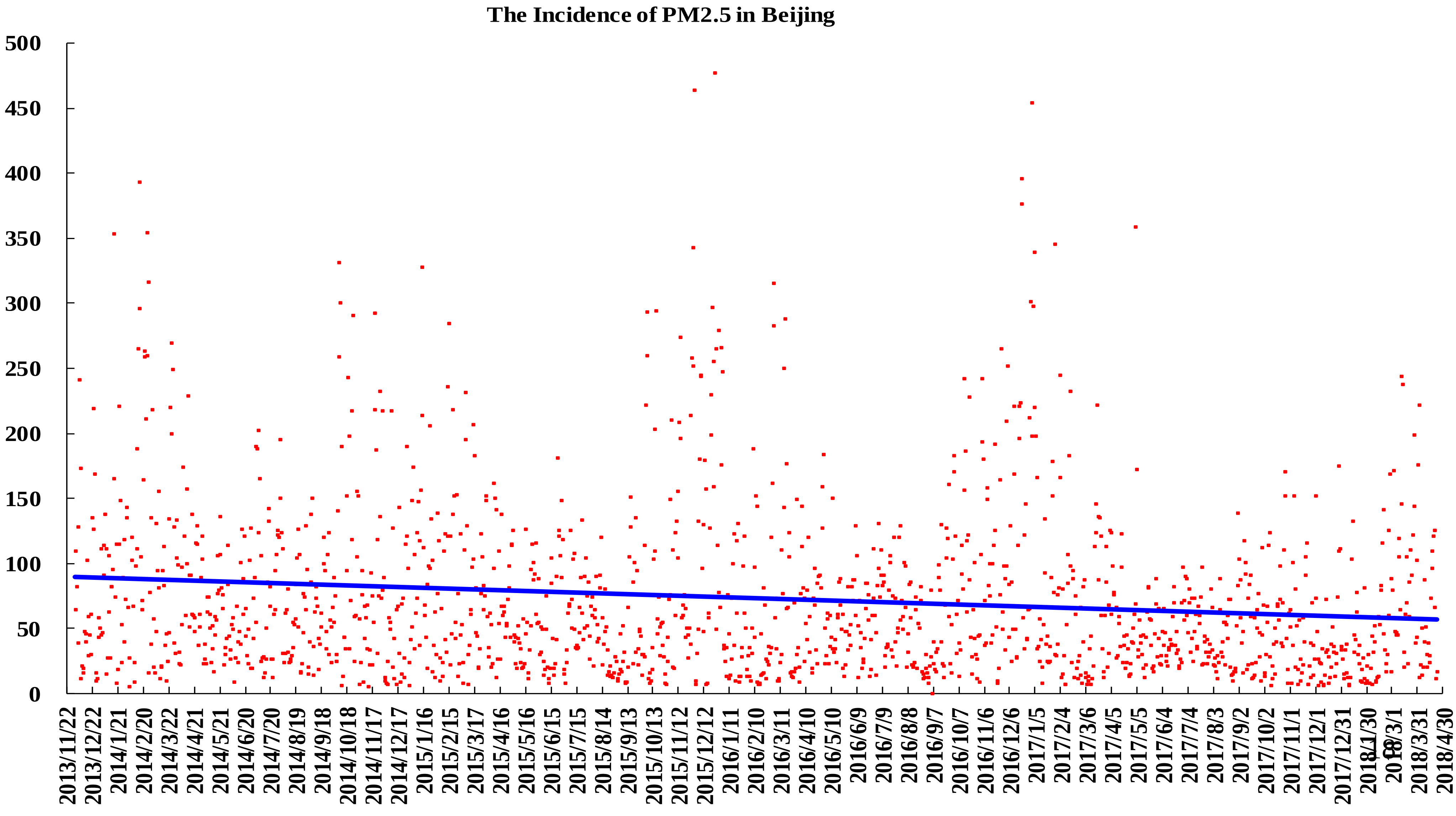
Enhance Quality: Increase Energy Efficiency and Reduce Pollution

- One measure of energy efficiency is the energy used per unit real GDP. In the following chart we compare the energy/GDP ratio of China, Japan and the United States in terms of million joules per unit real GDP in 2010 U.S. Dollars. (The Joule is a unit of energy and is equal to the more familiar 0.000948 BTU (British Thermal Unit)). It is clear that China has been improving its energy efficiency over time, which implies that overall carbon emission per unit real GDP is being reduced. However, it still has significant room to improve.
- Another measure of the quality of economic growth is the quantity of PM 2.5 particles in the air. Here we can also see from the data on Beijing the gradual improvement. As the quality of air has become a mandatory key performance indicator in the Thirteenth Five-Year Plan, it will likely continue to improve over time.

Final Energy Consumption/GDP Ratio for China, Japan and the U.S. (Million Joules/2010 US$)



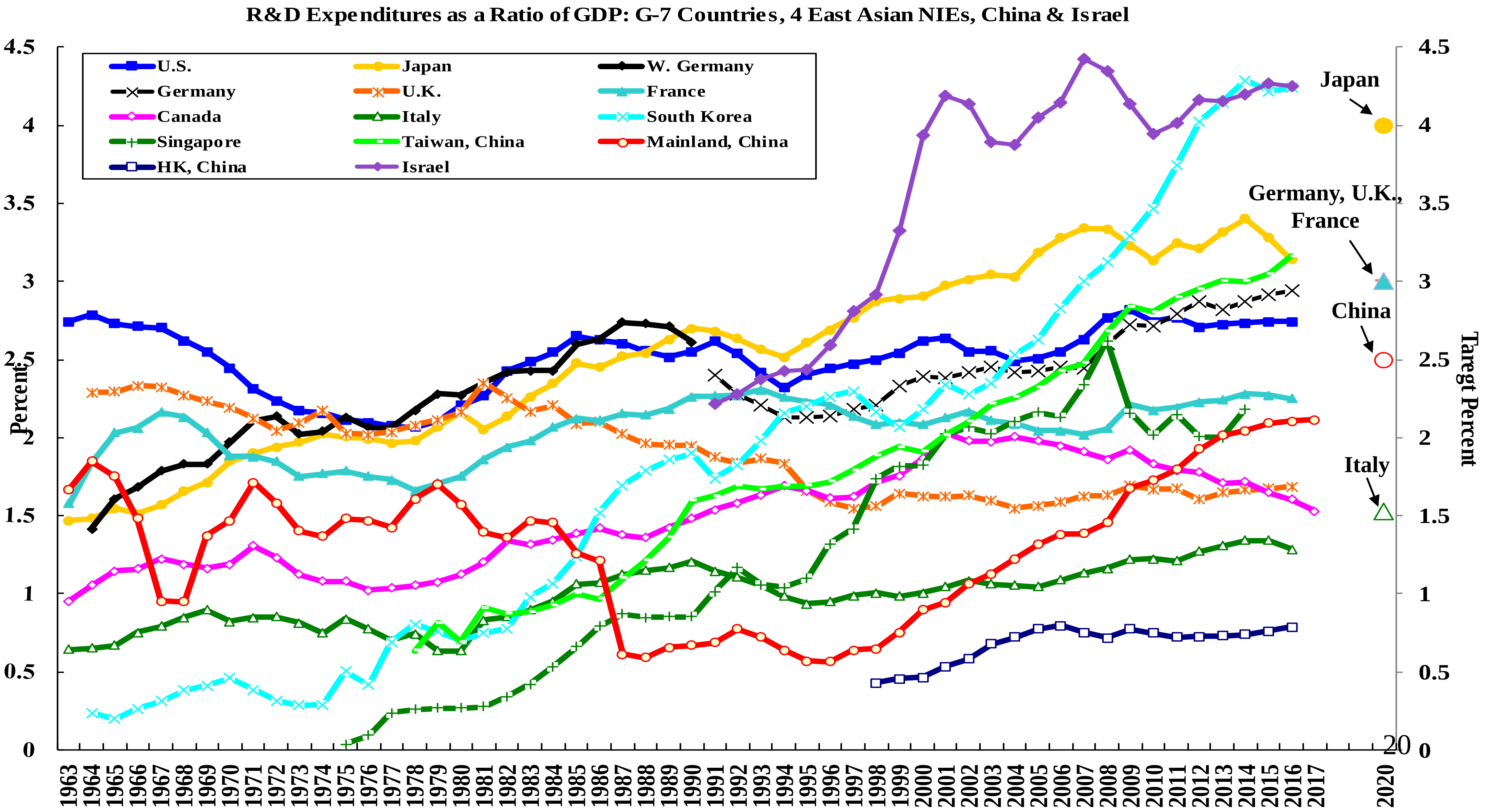
The Incidence of PM2.5 in Beijing: Daily Data from 2013M2 to 2018M4



Enhance Quality: Investment in Intangible Capital (Human and R&D Capital)

- Investment in intangible capital (human capital and Research and Development (R&D) capital) is indispensable for innovation.
- The annual expenditure on R&D as percentages of GDP are presented for selected economies in the following chart.
- The chart shows that the U.S. has consistently invested a relatively high percentage of its GDP in R&D averaging 2.5% since 1963. The East Asian economies, including Mainland China, has been catching up fast, with the exception of Hong Kong.
- China is expected to reach its target of 2.5% of GDP in 2020, approximately the same as the average U.S. share. However, it will still be below the expected or targeted levels of the European countries, Japan and South Korea.

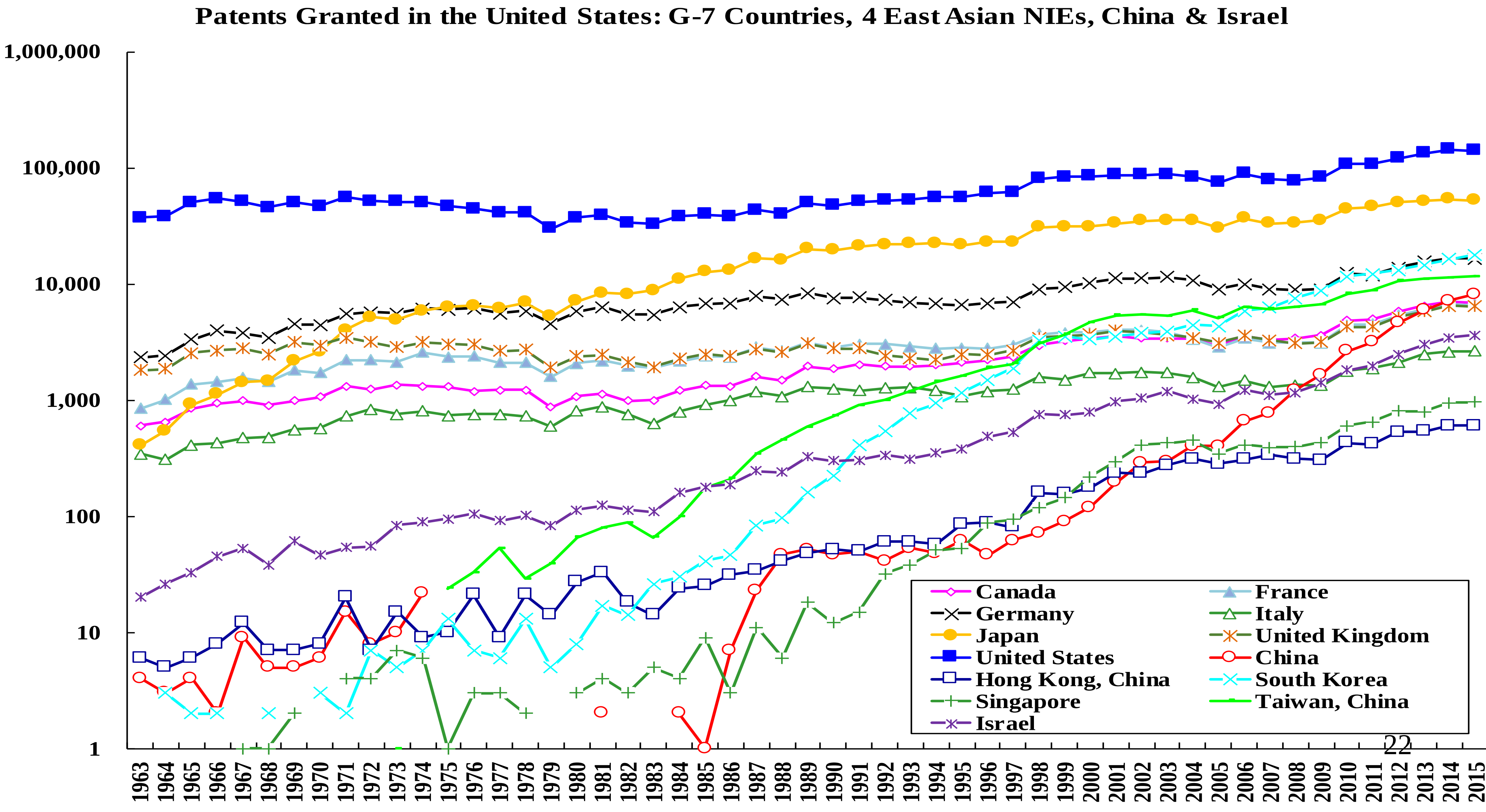
R&D Expenditures as a Share of GDP and Their Target Levels at 2020: G-7 Countries, 4 East Asian NIEs, China & Israel



Enhance Quality: Investment in Intangible Capital (R&D Capital)

- One indicator of the potential for technical progress is the number of patents created each year. In the following chart, the number of patents granted in the United States each year to the nationals of different countries, including the U.S. itself, over time is presented.
- The U.S. is the undisputed champion over the past forty years, with 140,969 patents granted in 2015, followed by Japan, with 52,409. (Since these are patents granted in the U.S., the U.S. may have a home advantage; however, for all the other countries and regions, the comparison across them should be fair.)
- The number of patents granted to Mainland Chinese applicants each year has increased from the single-digit levels prior to the mid-1980s to 8,166 in 2015.
- The economies of South Korea and Taiwan, granted 17,924 and 11,690 U.S. patents respectively in 2015, were far ahead of Mainland China. In contrast, the number of U.S. patents granted to Hong Kong nationals was only 601 in 2015.

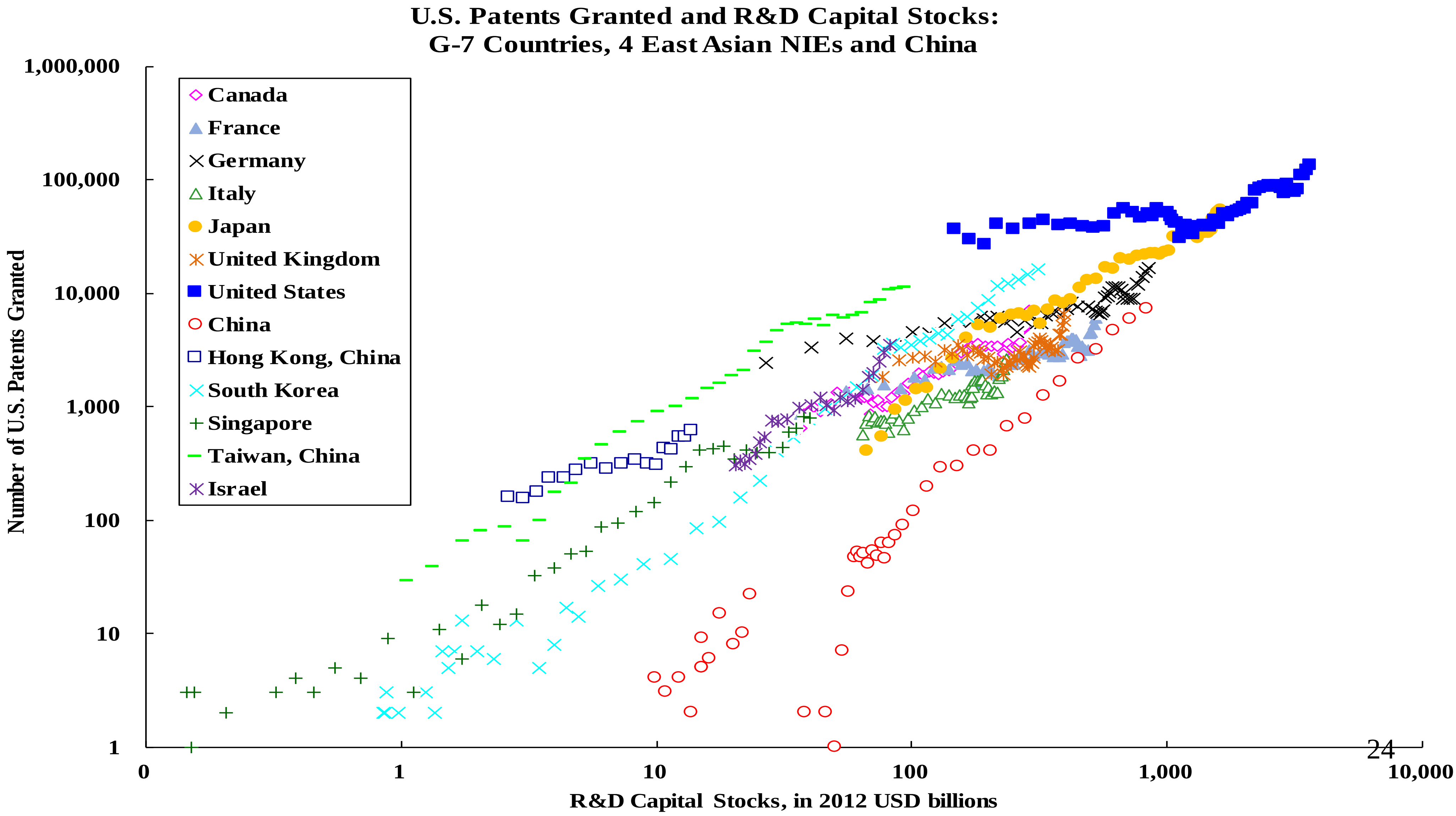
Patents Granted in the United States: G-7 Countries, 4 East Asian NIEs, China & Israel



Enhance Quality: Investment in Intangible Capital (R&D Capital)

- The R&D capital stock, defined as the cumulative past real expenditure on R&D less depreciation of 10% per year, is an useful indicator of innovative capacity. R&D expenditure should quite properly be treated as investment since R&D efforts generally take years to yield any results.
- The R&D capital stock can be shown to have a direct causal relationship to the number of patents granted (see the following chart, in which the annual number of U.S. patents granted is plotted against the R&D capital stock of that year for each economy).
- The chart shows clearly that the higher the stock of R&D capital of an economy, the higher is the number of patents granted to it by the U.S.

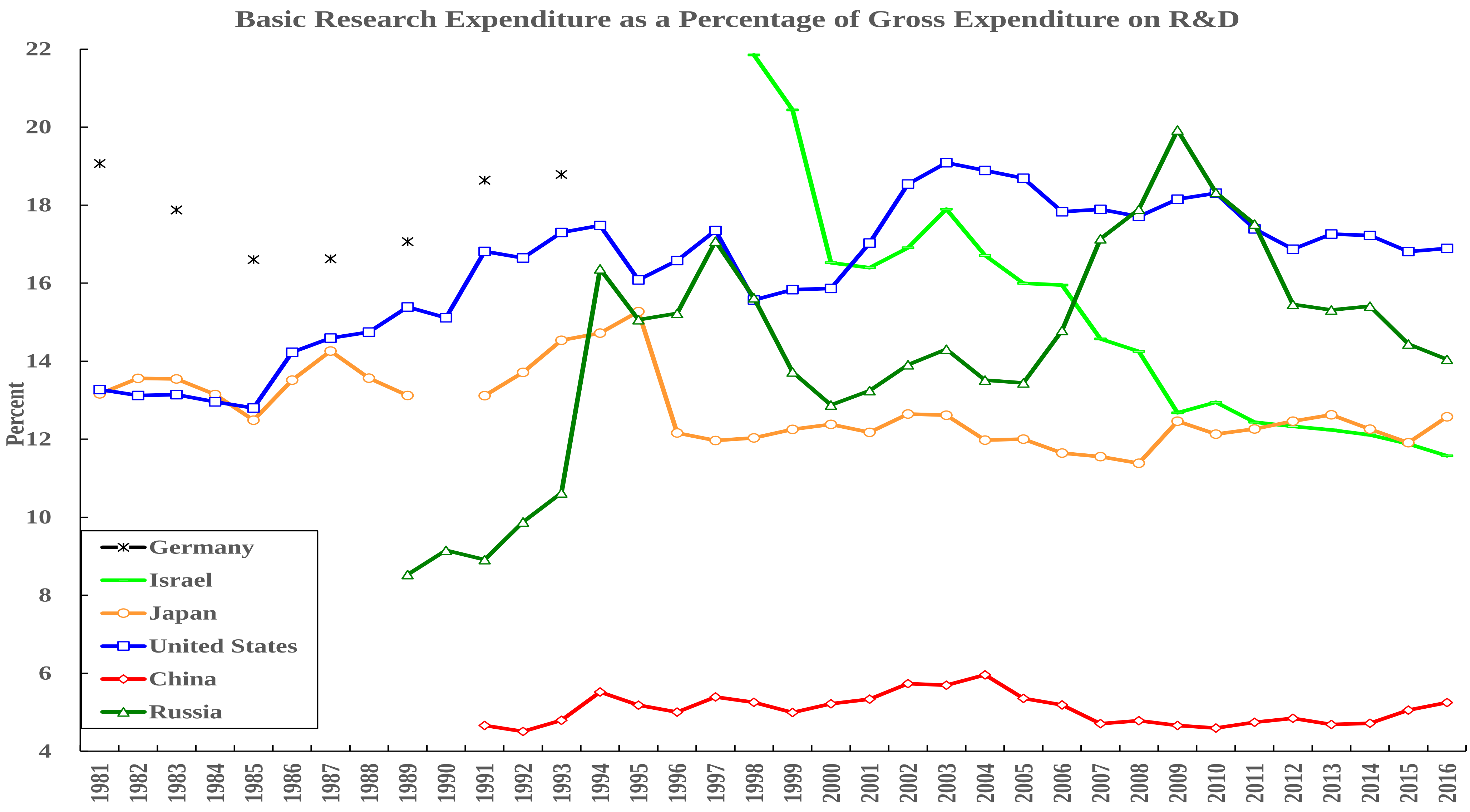
U.S. Patents Granted and R&D Capital Stocks: G-7 Countries, 4 EANIEs, China & Israel



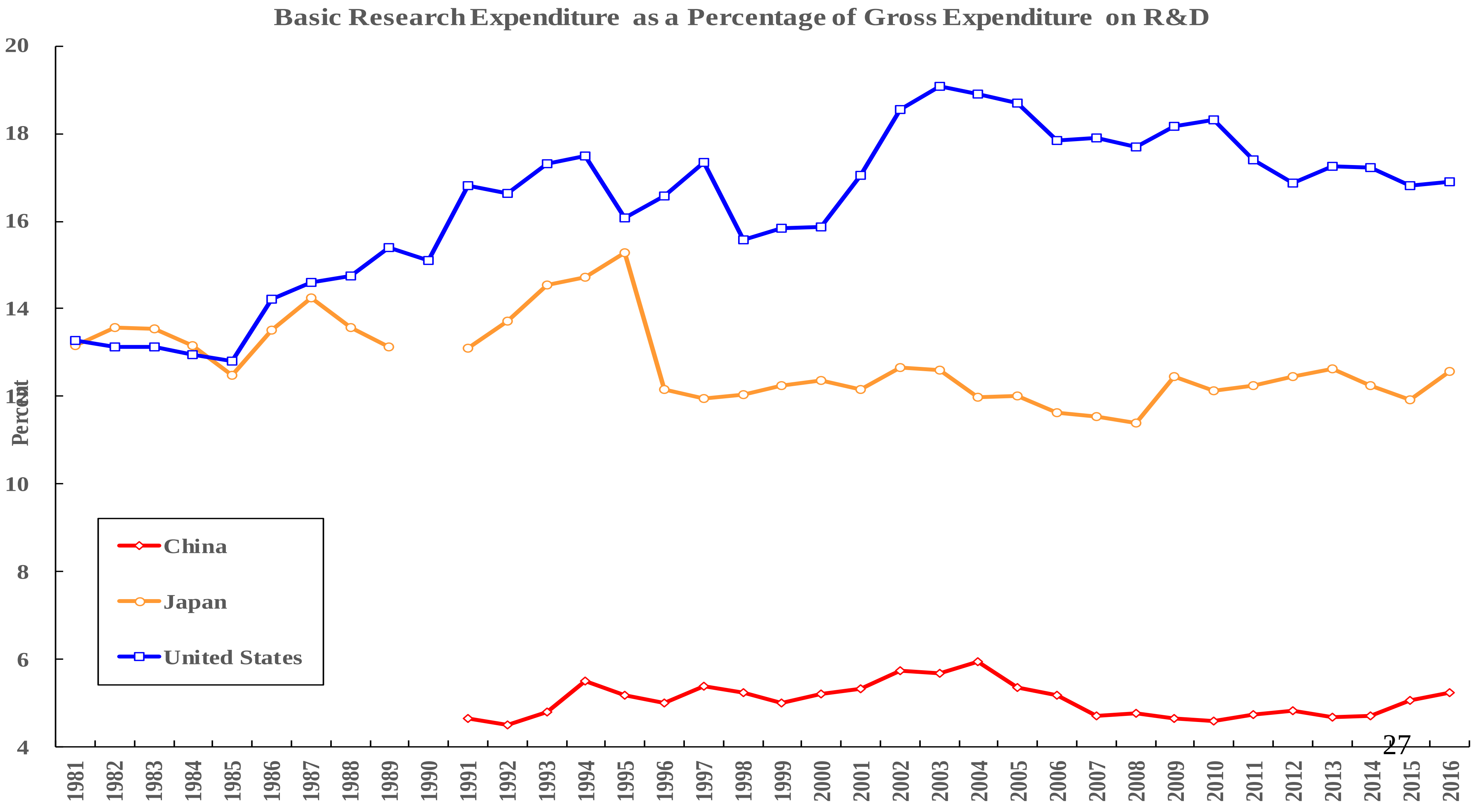
Enhance Quality: Investment in Intangible Capital (R&D Capital)

- In order for break-through discovery or invention to be made, there must be significant investment in basic research.
- Basic research is by definition patient and long-term research. The rate of return, at any reasonable discount rate, will be low. It must therefore be financed by the government or non-profit institutions and not by for-profit firms.
- The atomic and hydrogen bombs, the nuclear reactors, the internet, the packets transmission technology and the browser are all outcomes of basic research done many years ago.
- However, Chinese investment in basic research has remained low relative to the other major countries (see the following chart). China devoted only 5 percent of its R&D expenditures to basic research, compared to the more than 15 percent of the U.S.

Basic Research Expenditure as a Share of Total R&D Expenditure: Selected Countries



Basic Research Expenditure as a Share of Total R&D Expenditure: Selected Countries



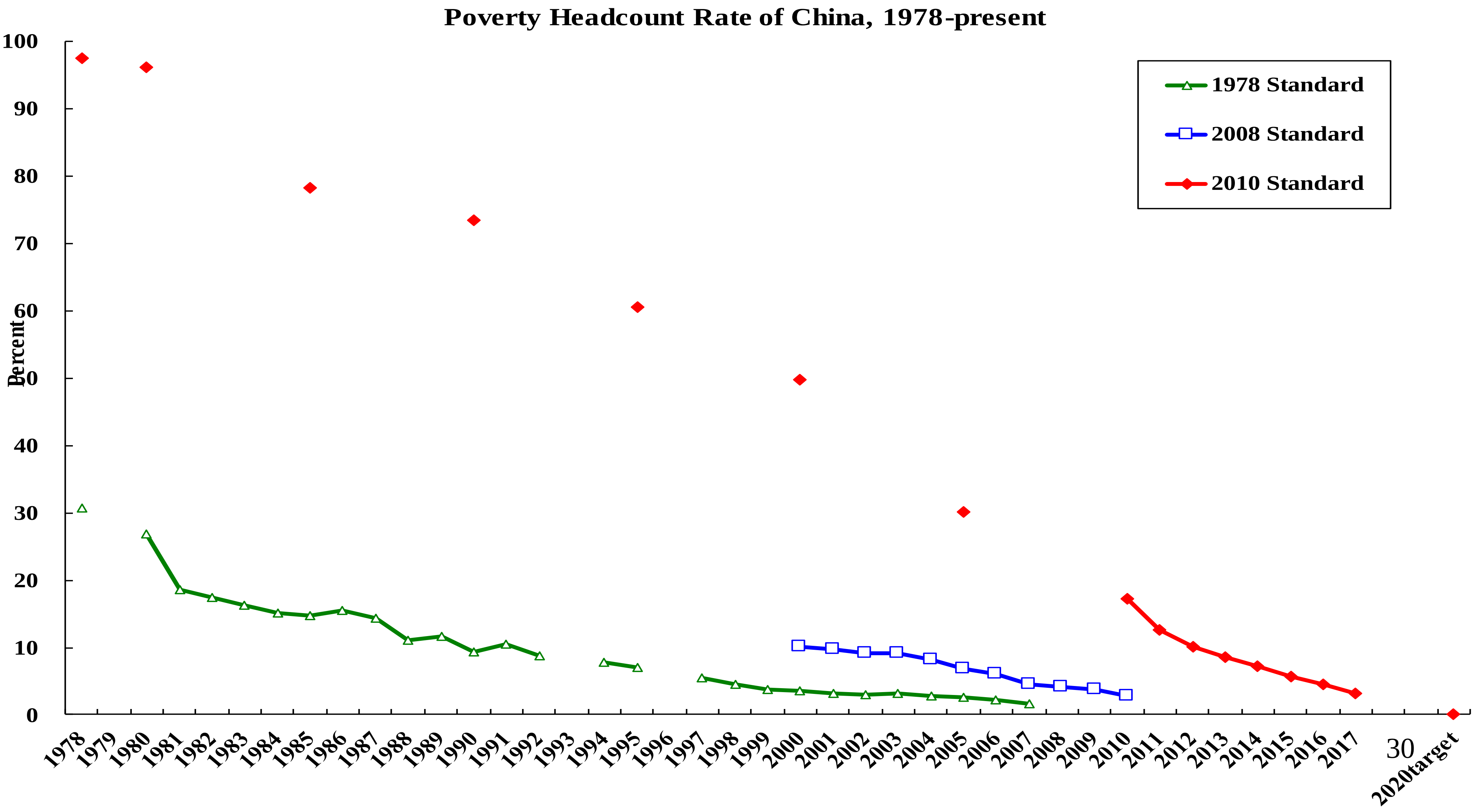
Share Prosperity

- The distribution of income is a separate issue altogether. It is interesting to note that both China before the economic reform and Taiwan until the 1990s had one of the most egalitarian distributions of household income in the world, despite very different economic systems. The Scandinavian countries, which also have different political and economic systems, have always had relatively egalitarian distributions of income.
- During the past couple of decades, the global distribution of income has become more egalitarian at the same time that within each economy, the distribution of income has become more unequal. This is the combined result of economic globalization and technological innovation.
- The Chinese labor share of GDP as well as its household share of GDP have been consistently significantly lower than those in other economies, developed and developing. There is significant room for China to increase its labor share of GDP through increasing the rate of growth of wages to above the rate of growth of GDP for a couple of decades. This should eventually result in a higher share of household consumption in GDP, similar to other economies. Excess savings will fall and the trade surplus will eventually disappear.

Share Prosperity

- The poverty headcount rate of China has been declining continuously since the economic reform began in 1978. According to the 2010 standard of poverty, over 95% of the Chinese population was below the poverty line in 1978. Today that share would be below 5%. It is expected that by 2020, poverty according to the 2010 standard will have been completely eradicated.

Poverty Headcount Rate of China, 1978-present



Reduce Risks

- The major risk to the Chinese economy is the systemic risk in the financial sector. The failure of a large enterprise may lead to the failure of its creditors, contractors and suppliers, with significant spillover effects, especially if the degree of leverage of the enterprise is high.
- At year-end 2016, the total debt of all kinds to GDP ratio was 247% in China. It was believed to be more or less the same at year-end 2017. However, the central government debt to GDP ratio was below 20% at year-end 2017, compared to almost 100% for the U.S. and 250% for Japan. At year-end 2017, official local government debt was 16.47 trillion Yuan and total local government liability was estimated to be around 31 trillion Yuan, or not quite 40% of a Chinese GDP of 82.7 trillion Yuan. The rest of the Chinese debt consists mostly of enterprise debt and household debt, for which the central government does not provide a guarantee and has no responsibility for repayment.

Reduce Risks

- In 2017Q3, publicly listed Chinese enterprises had an average debt to assets ratio of 60% or a debt to equity ratio of approximately 150%, which is on the high side. But enterprises, unlike the government, have net assets (positive net worth).
- Moreover, almost all of the public debt and the great majority of the enterprise and household debt are denominated in Renminbi and held by Chinese nationals. So any problem should be quite manageable, especially given the high national savings rate of China in the mid-forties.
- Nevertheless, shadow banking, financial derivatives, and internet-related financial fraud can create significant problems if not adequately monitored and regulated.

Towards a Modern Socialist Market Economy: Continuity of Governance

- One common feature of the early development stages of the East Asian economies is that they were all characterized by continuous one-party rule, beginning with the Liberal Democratic Party in Japan, the British Colonial Government in Hong Kong, the Kuomintang (Nationalist Party) in Taiwan, President PARK Chung-Hee in South Korea, Prime Minister LEE Kuan Yew and his People's Action Party of Singapore, and then the Communist Parties of China and Vietnam.

- The advantages of continuous one-party rule are:

  - (1) It is possible to plan long-term, without regard to the election cycle, as there is no need to settle for only short-term outcomes (basic infrastructure, so critical in the early development stage, can only be provided by a government with a long-term perspective);

  - (2) There is consistency, continuity and predictability in economic policy; and

  - (3) The households and enterprises can share a common long-term vision and common expectations about the future, facilitating investment planning and coordination.

- Of course, this is not to say that there are no disadvantages to continuous one-party rule. Many countries governed by long-term dictatorships are among the poorest in the world. But when one-party rule works well, it is better and more efficient than any other system.

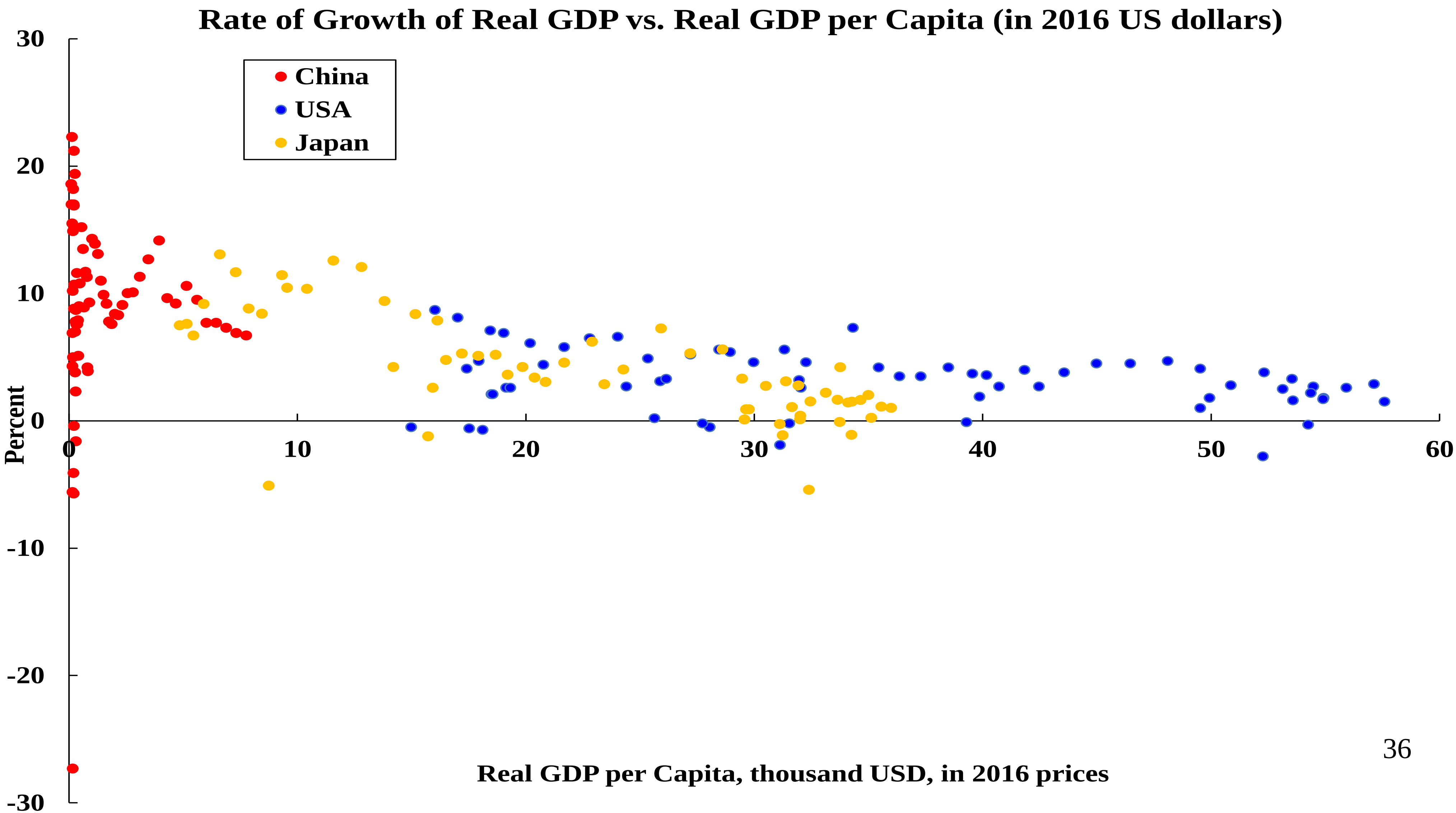
Towards a Modern Socialist Market Economy

- President XI Jinping wants to strengthen the party so that it can provide the leadership for achieving the tasks of the New Era. He wants to ensure the faithful implementation and execution of the policies adopted by the Communist Party of China.
- He wishes to transform the party cadres into a dedicated and incorruptible "priesthood", so that the Party can continue to not only survive but also to thrive for many more decades. Ultimately, he wants all the party cadres not to be corrupt not only because they are deterred by potential punishment, and not only because the operating system prevents them from doing so, but also because they genuinely do not want to be corrupt. This is "socialism with Chinese characteristics".
- Under both the socialist and capitalist market systems, there is an agency problem in the sense that the managers of the enterprises may not act in the best interests of the owners (shareholders) of the enterprises. If the managers themselves are more public-spirited and less self-centered, then the probability is higher that their interests and those of the owners are more aligned. Corruption is the result of an agent pursuing his or her own interests rather than those of the principal.

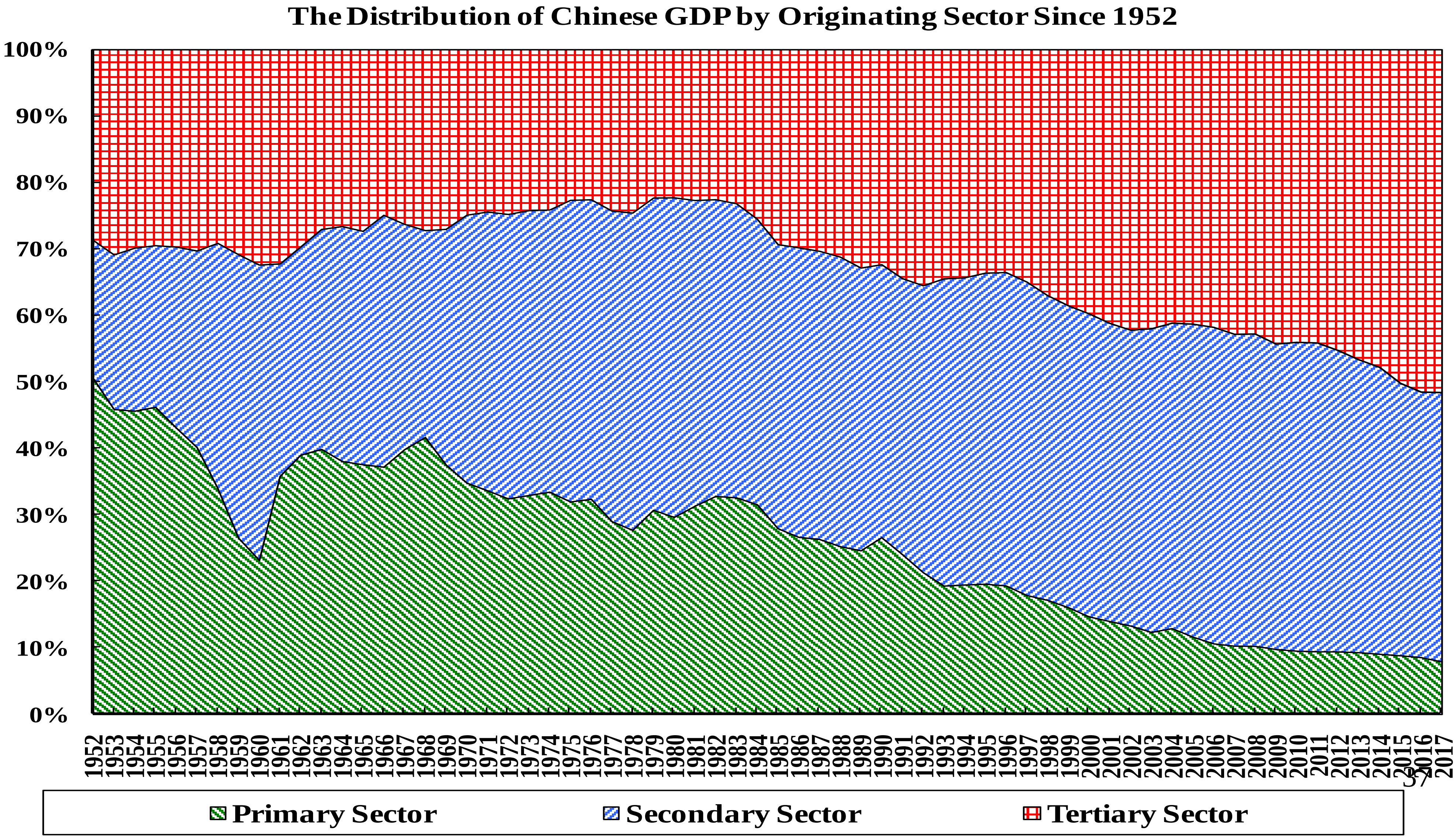
Projections of the Future: Long-Term Forecasts of the Chinese and the U.S. Economies

- It is assumed that the Chinese economy will continue to grow above 6% per annum for a few more years, declining gradually to between 5% and 6%, and that the U.S. economy will grow at an average rate of 3% per annum between now and 2050.
- It may be thought that the Chinese economy will be unable to sustain an average annual rate of growth of between 5% and 6% for such a long time. Experience shows that the rate of growth of an economy declines as its real GDP per capita rises. But given the still relatively low level of real GDP per capita in China, and the low level of its capital per unit labor, such a rate of growth should still be possible for at least several decades (see the following chart in which the experiences of China, Japan and the U.S. are compared.)
- In addition, there is still significant surplus labor in the Chinese economy. The share of employment in the primary sector is around 30% whereas the share of GDP originating from the primary sector is below 10%.

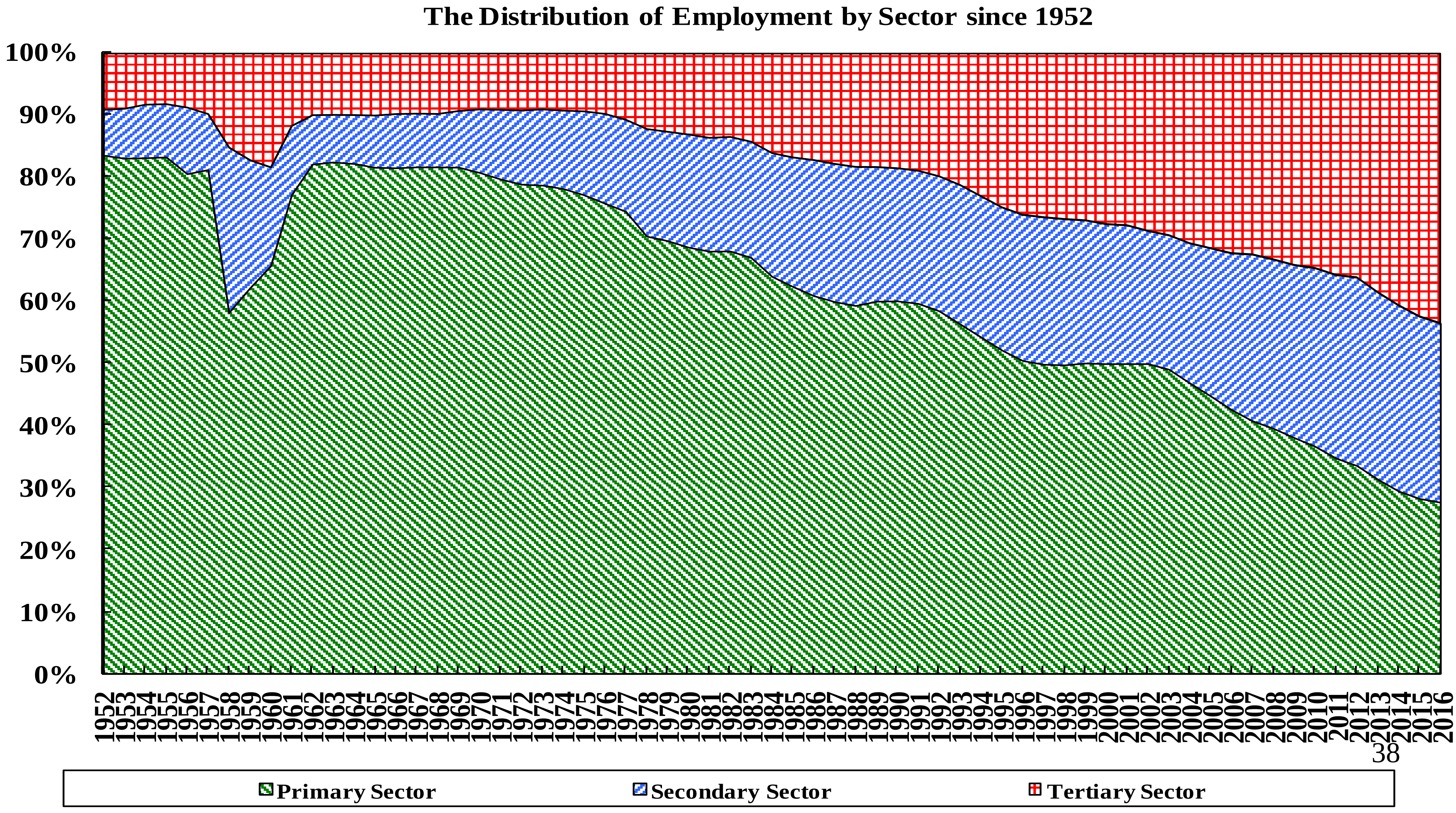
Growth Rates vs. Levels of Chinese, U.S. and Japanese Real GDP per Capita (2016 tril. US$)



The Distribution of Chinese GDP by Sector Since 1952



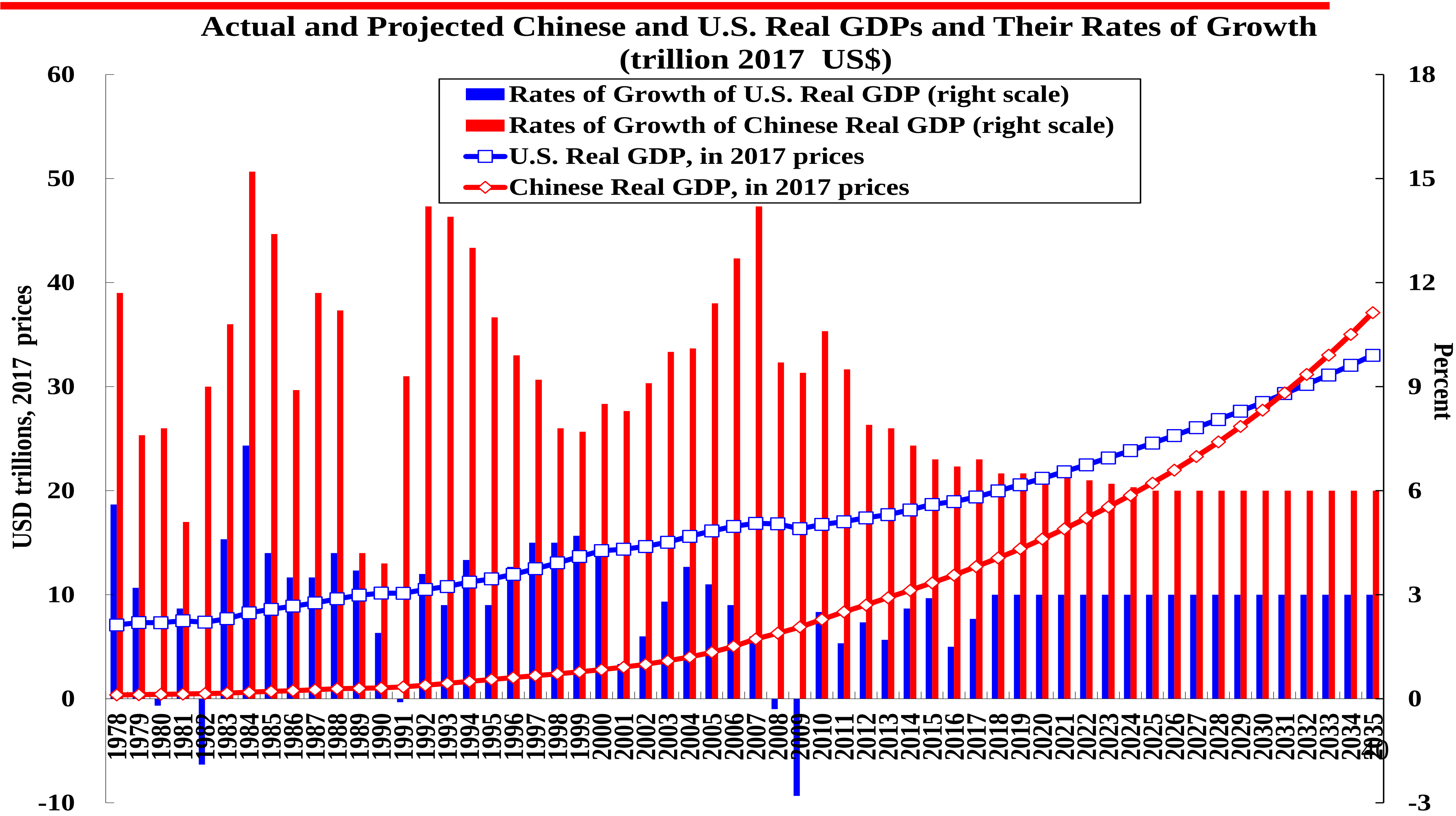
The Distribution of Chinese Employment by Sector Since 1952



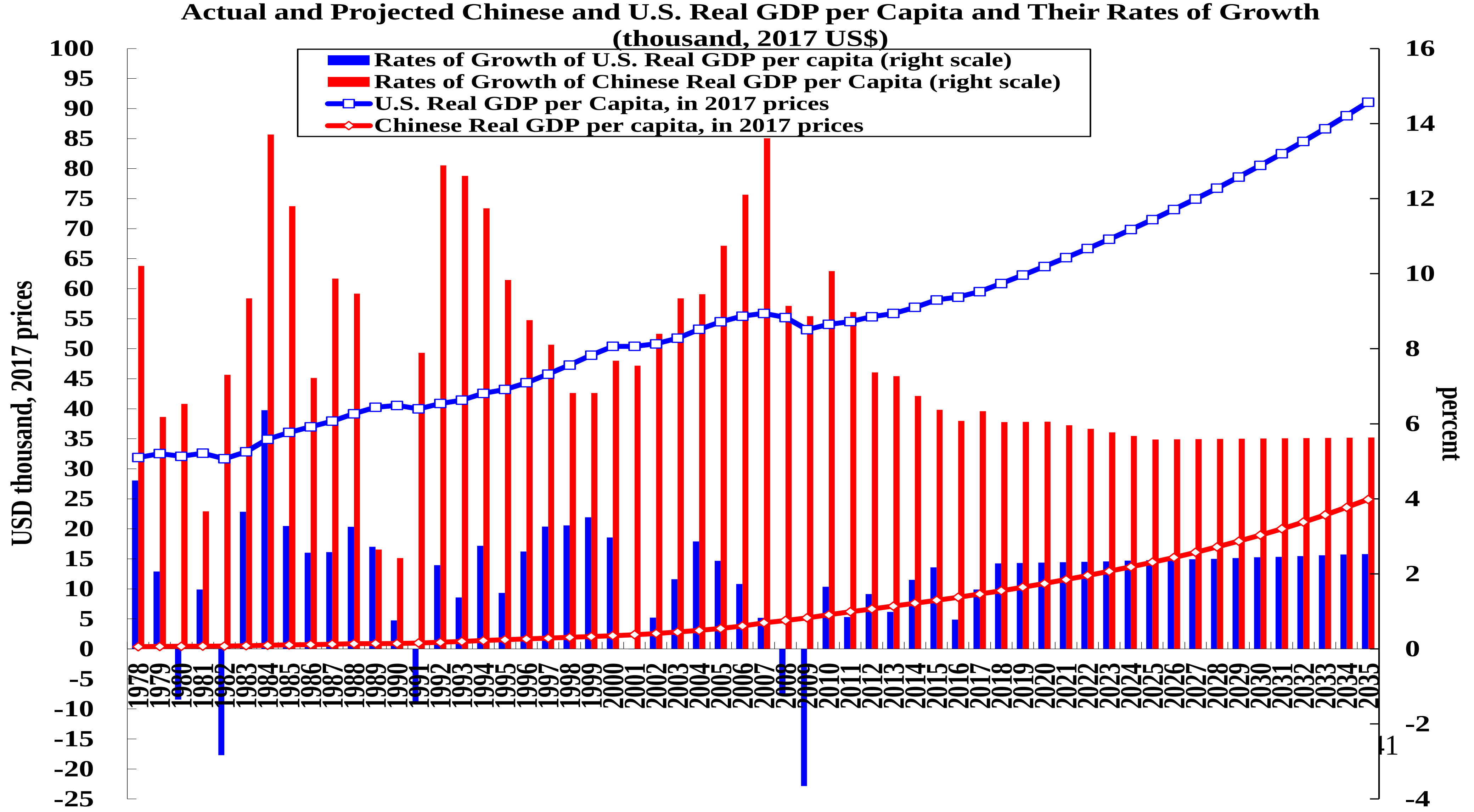
Projections of the Chinese and the U.S. Economies

- In his work report to the Nineteenth National Congress of the Communist Party of China, President XI Jinping identified several Chinese development milestones at 2020, 2035 and 2050.
- The first milestone is to become a moderately well-off society by 2020. Our projections show that by 2020, Chinese real GDP per capita (in 2017 prices) will exceed US$10,898 (compared to US$63,703 for the U.S.).
- Our projections also show that by 2031, Chinese real GDP will surpass U.S. real GDP (US$29.4 trillion versus US$29.3 trillion), making China the largest economy in the world. However, in terms of real GDP per capita, China will still lag behind significantly, with US$20,009 compared to US$82,502 for the U.S.
- By 2050, Chinese real GDP will reach US$82.6 trillion compared to US$51.4 trillion for the U.S. In terms of real GDP per capita, China will reach US$52,870, slightly less than the current level of U.S real GDP per capita, compared to US$134,071 for the U.S.
- It will not be until the end of the 21st Century for the Chinese real GDP per capita to catch up with the U.S. real GDP per capita.

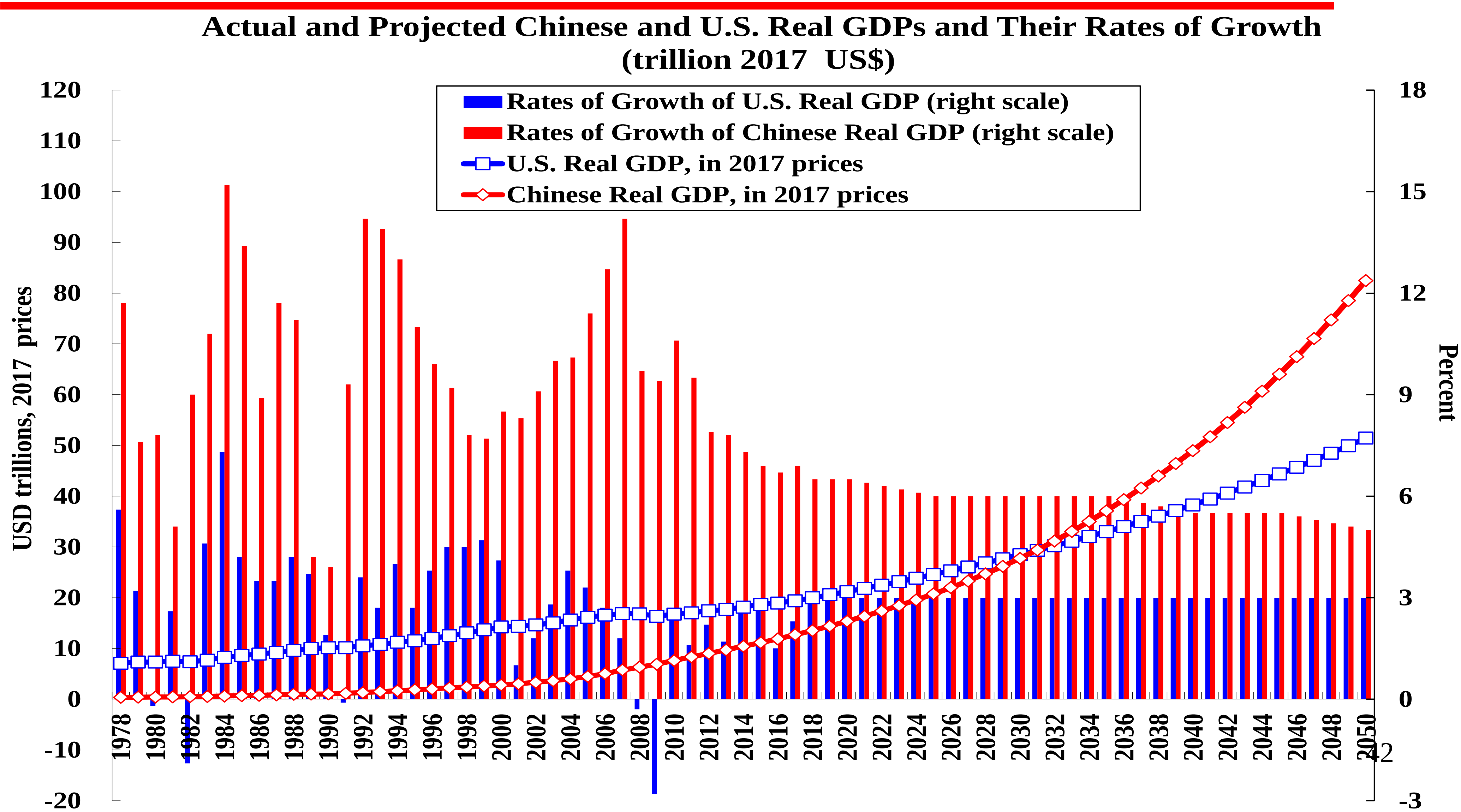
Actual and Projected Levels and Growth Rates of Chinese and U.S. Real GDP (2017 tril. US$)



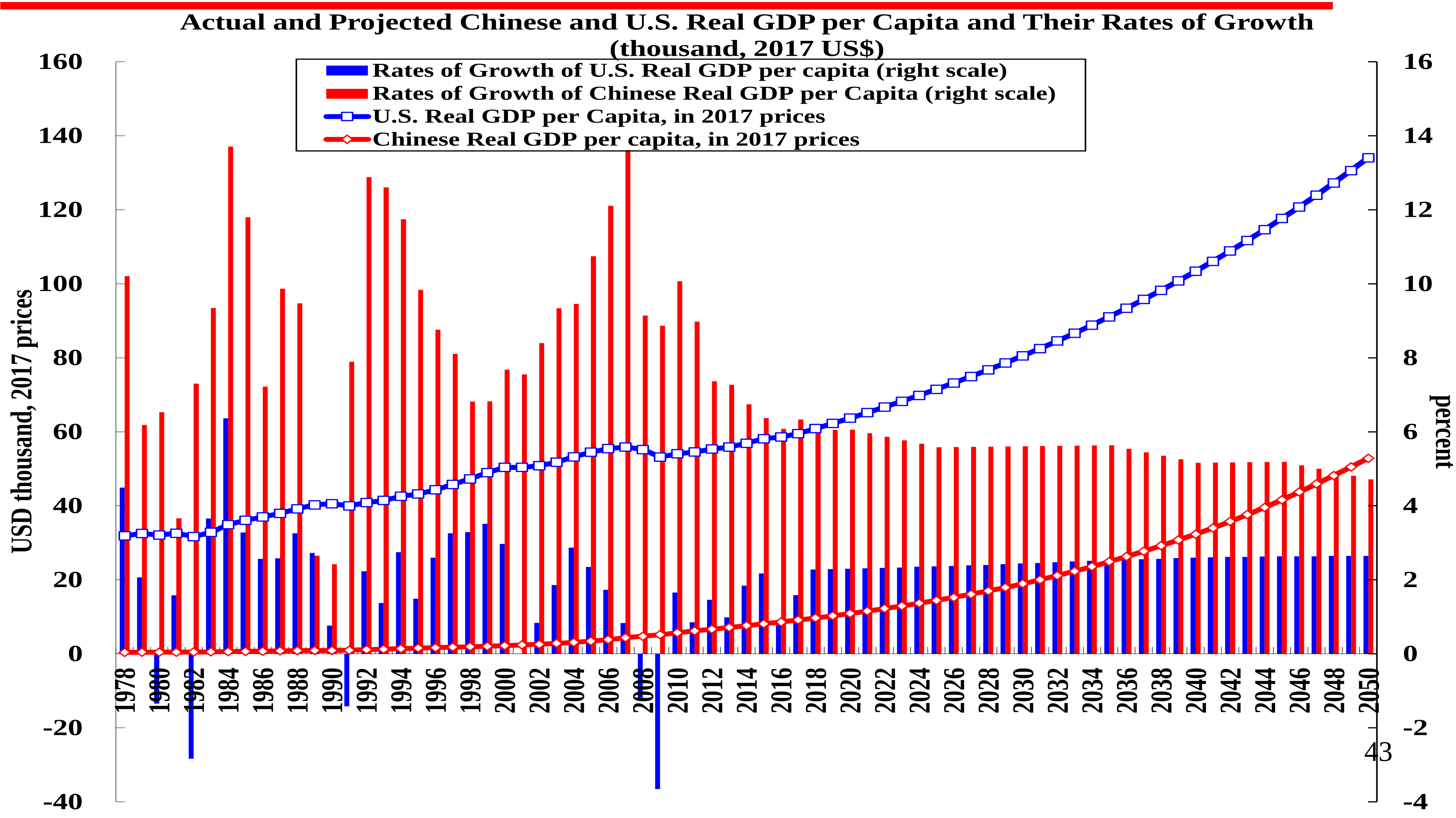
Actual and Projected Chinese and U.S. Real GDP/ Capita and Their Rates of Growth (1,000 2017 US$)



Actual and Projected Levels and Growth Rates of Chinese and U.S. Real GDP (2017 tril. US$)



Actual and Projected Chinese and U.S. Real GDP/ Capita and Their Rates of Growth (1,000 2017 US$)



Concluding Remarks

- The New Era will be transformative of the Chinese economy. China will join the ranks of developed economies of the world.
- It will be more household consumption-driven than investment driven. It will be more innovation-driven than inputs-driven. It will be more quality-motivated than quantity-motivated.
- The New Era will restore green mountains, blue skies and clear waters in China.
- There will be an improved social safety net, assuring shared prosperity for all in the New Era!