

# Perspectives on the Chinese Economy

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Lawrence J. Lau, Ph. D.\*

Chairman, CIC International (Hong Kong) Co., Limited  
and

Kwoh-Ting Li Professor in Economic Development, Emeritus, Stanford University

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Tel: (852)3710-6888; Fax: (852)2104-6938

Email: [lawrence@lawrencejlau.com](mailto:lawrence@lawrencejlau.com); WebPages: [www.igef.cuhk.edu.hk/ljl](http://www.igef.cuhk.edu.hk/ljl)

\*All opinions expressed are the author's own and do not reflect the views of any of the organisations with which the author is affiliated

# Outline

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- ◆ An Overview of the Chinese Economy
- ◆ The Economic Fundamentals
- ◆ The Twelfth Five-Year Plan
- ◆ The Internationalisation of the Renminbi
- ◆ Projections of the Future
- ◆ Concluding Remarks

# An Overview of the Chinese Economy

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- ◆ 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 9.8% per annum over the past 33 years. It is historically unprecedented for an economy to grow at such a high rate over such a long period of time.
- ◆ China is one of the very few socialist economies that have made a smooth transition from a centrally planned to a market system. It is a model for other transition economies such as Vietnam and potential transition economies such as Cuba, Laos, and North Korea.

# An Overview of the Chinese Economy

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- ◆ Between 1978 and 2010, Chinese annual real GDP grew more than 20 times, from US\$304 billion to more than US\$6.04 trillion (2010 prices) to become the second largest economy in the World, after the United States.
- ◆ By comparison, the U.S. GDP (approximately US\$14.66 trillion in 2010 prices) was 2.4 times the Chinese GDP in 2010.

# An Overview of the Chinese Economy

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- ◆ Despite the rapid economic growth of China, in terms of real GDP per capita, it is still a developing economy.
- ◆ Between 1978 and 2010, Chinese real GDP per capita grew almost 15 times, from US\$316 to US\$4,503 (in 2010 prices). By comparison, the U.S. GDP per capita (approximately US\$47,274 in 2010 prices) was 10.5 times Chinese GDP per capita in 2010.
- ◆ Chinese GDP per capita ranks below 90th among all countries in the World.

# An Overview of the Chinese Economy

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- ◆ While many problems have arisen in the Chinese economy within the past decade—for example, increasing income disparity--both inter-regional and intra-regional--uneven access to basic education and health care, environmental degradation, inadequate infrastructure and corruption—it is fair to say that every Chinese citizen has benefitted from the economic reform and opening since 1978, albeit to varying degrees, and few want to return to the central planning days.
- ◆ The Chinese Government leaders have also demonstrated their ability to confront important challenges and solve difficult problems, as for example, in maintaining Chinese economic growth during the 1997-1998 East Asian currency crisis and the 2007-2009 global financial crisis.

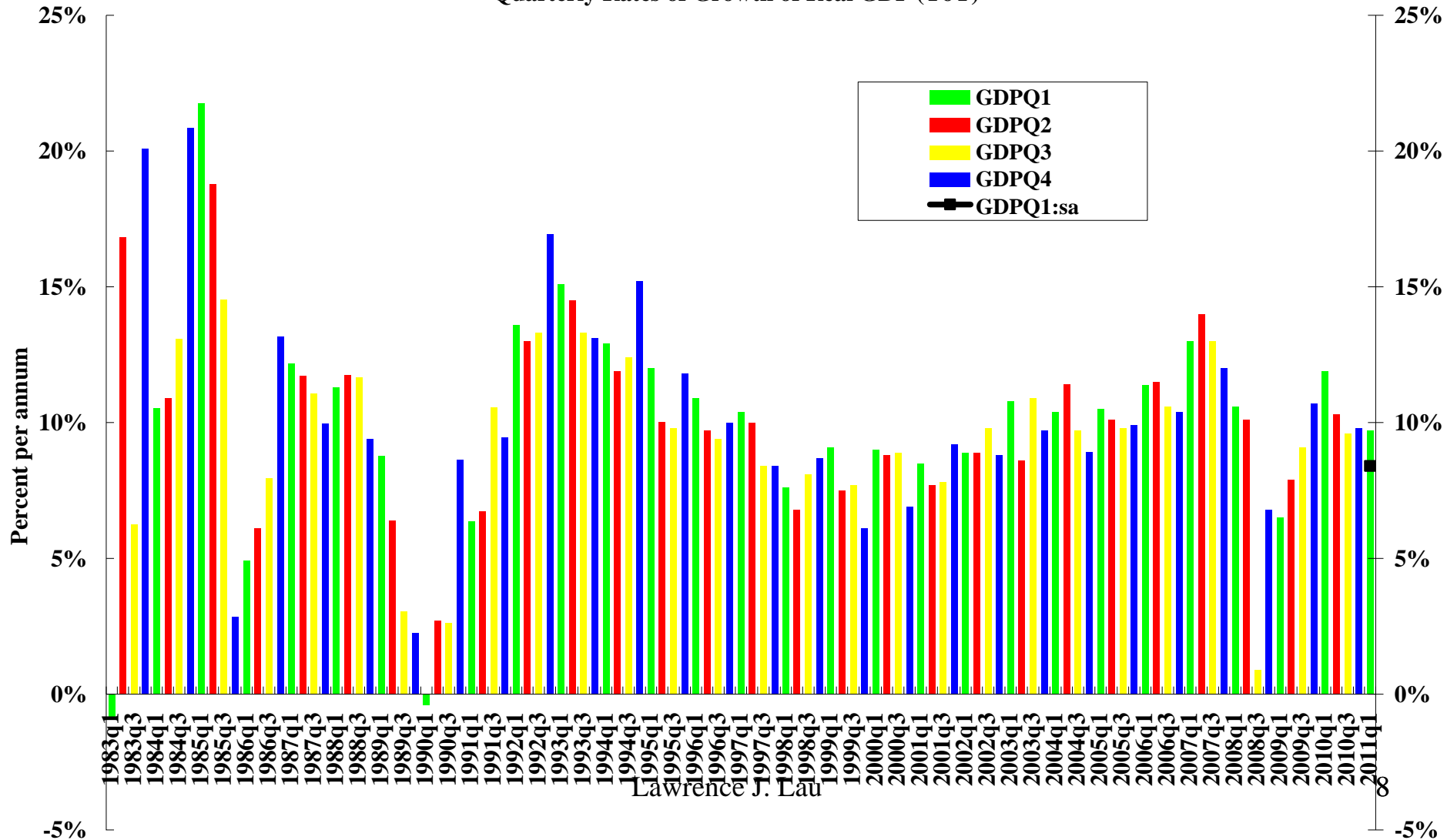
# The Macroeconomic Outlook

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- ◆ The Chinese economy grew 9.1% in 2009 and 10.3% in 2010 even as the European and U.S. economies remained in recession.
- ◆ The outlook is that there will be a gradual slowdown in the real rate of growth of the economy in 2011, to perhaps around 8%, which is actually a positive development for the Chinese economy.
- ◆ While 8% may seem like a significant reduction from 10.3%, there are reasons to believe that the impact of the economic slowdown on Chinese employment will not be that severe.
- ◆ For 2011Q1, the seasonally adjusted rate of growth was 8.4%, confirming that a slowdown has already begun.

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

Quarterly Rates of Growth of Real GDP (YoY)



Lawrence J. Lau



# The Macroeconomic Outlook

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- ◆ For 2010 as a whole, the rate of inflation of the prices of goods and services, as measured by the consumer price index (CPI), exceeded the objective of the Chinese Government of 3% slightly, at 3.3%.
- ◆ The CPI rose above 5% year-over-year in the first months of 2011.

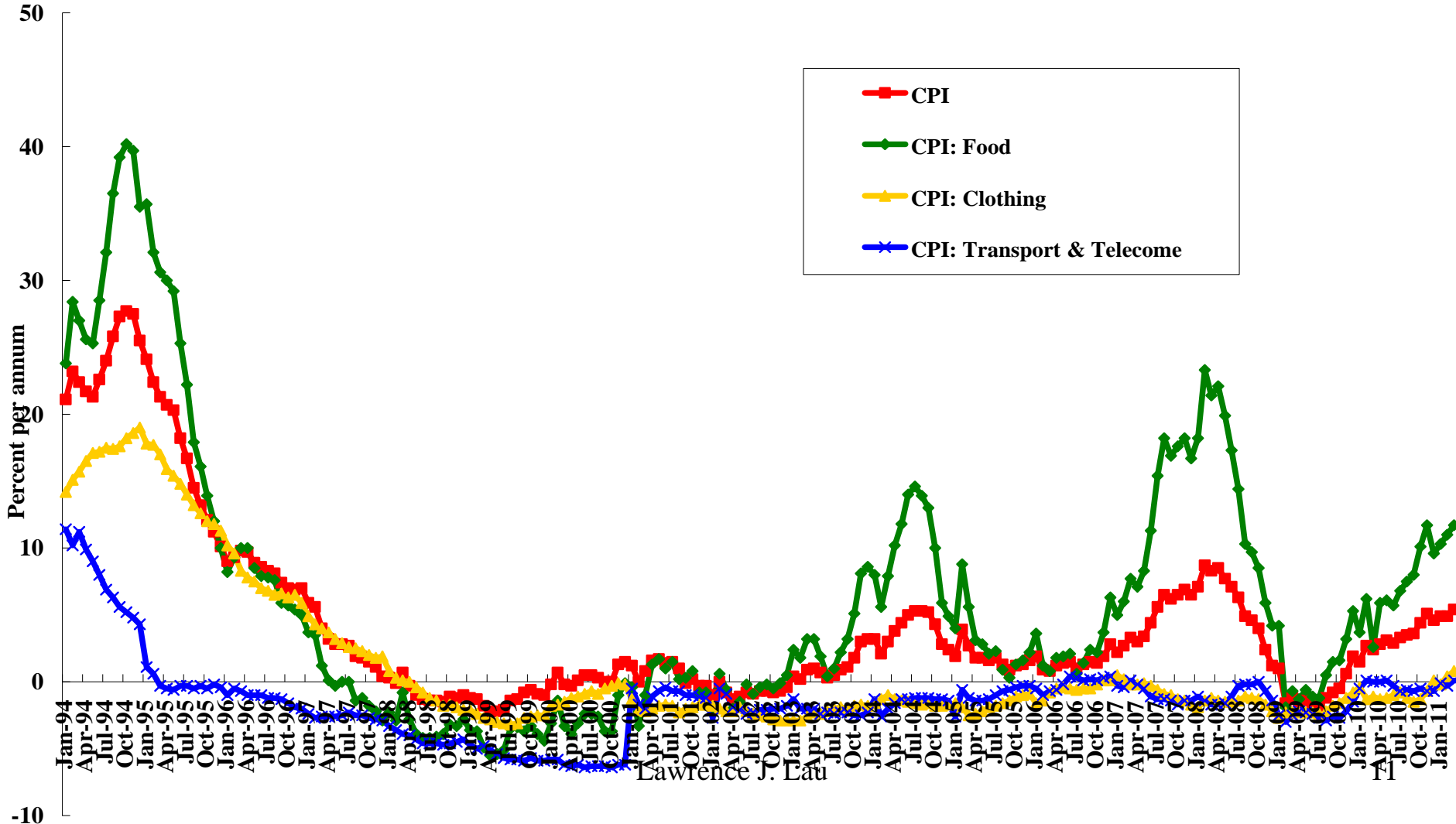
# The Macroeconomic Outlook

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- ◆ However, the bulk of the increase in the consumer price index (approximately 70%) in 2010 was caused by the increase in food prices (principally vegetables), due mostly to weather and possibly also to some hoarding and market manipulation but not to monetary factors.
- ◆ The core rate of inflation, that is, the rate of inflation net of the changes in the prices of agricultural and energy goods, has remained relatively tame at the 1-1.5% per annum level, as has been the case in the past few years.
- ◆ Moreover, given the excess production capacity in many key industries, such as steel, cement, and glass, it is unlikely that there will be much inflation in the prices of non-agricultural goods in the next couple of years.

# Monthly Rates of Change of the Consumer Price Index (CPI), Y-o-Y

Monthly Rates of Change of Consumer Price Index and Its Components Since 1994, Y-o-Y



# The Macroeconomic Outlook

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- ◆ Yet there has been significant inflation in the prices of assets such as real estate since 2009 due in part to the implementation of the 4 trillion Yuan economic stimulus package and the significant increases in the rates of growth of money supply and commercial bank credit.
- ◆ Measures have been taken recently to contain the asset price bubble. State-owned enterprises that have not been explicitly authorised are now forbidden to invest in real estate. Bank lending rules have also been tightened so as to discourage the purchases of more than one residential unit by a single household. Non-local residents may have to wait years before being allowed to purchase a residential unit in some localities.

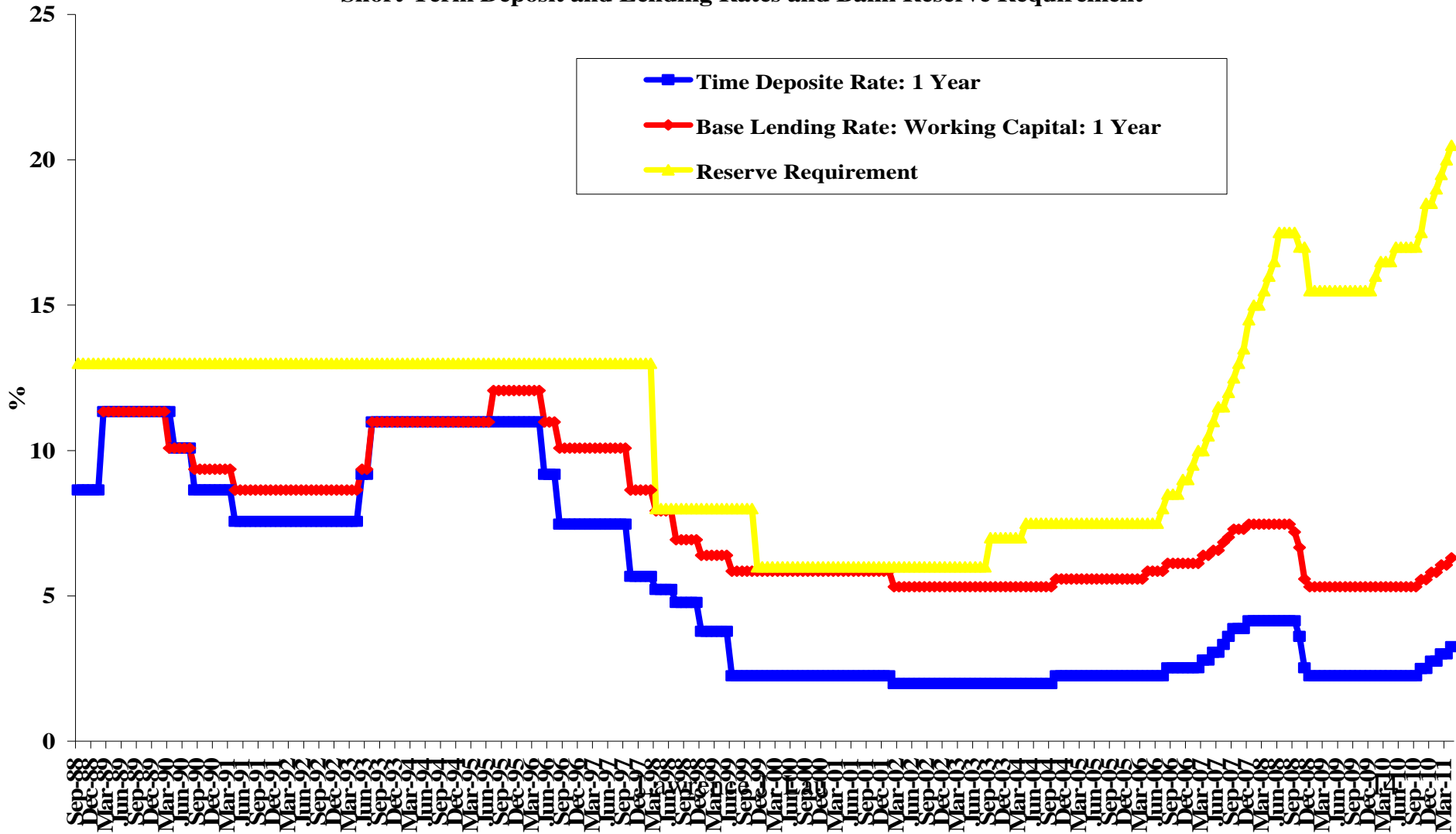
# The Macroeconomic Outlook

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- ◆ Recently, the People's Bank of China, the central bank, has increased the rates of interest (the minimum lending rate and the maximum deposit rate) and the reserve requirement ratio repeatedly.
- ◆ The rates of growth of money supply (both M1 and M2) and loans have also declined significantly.

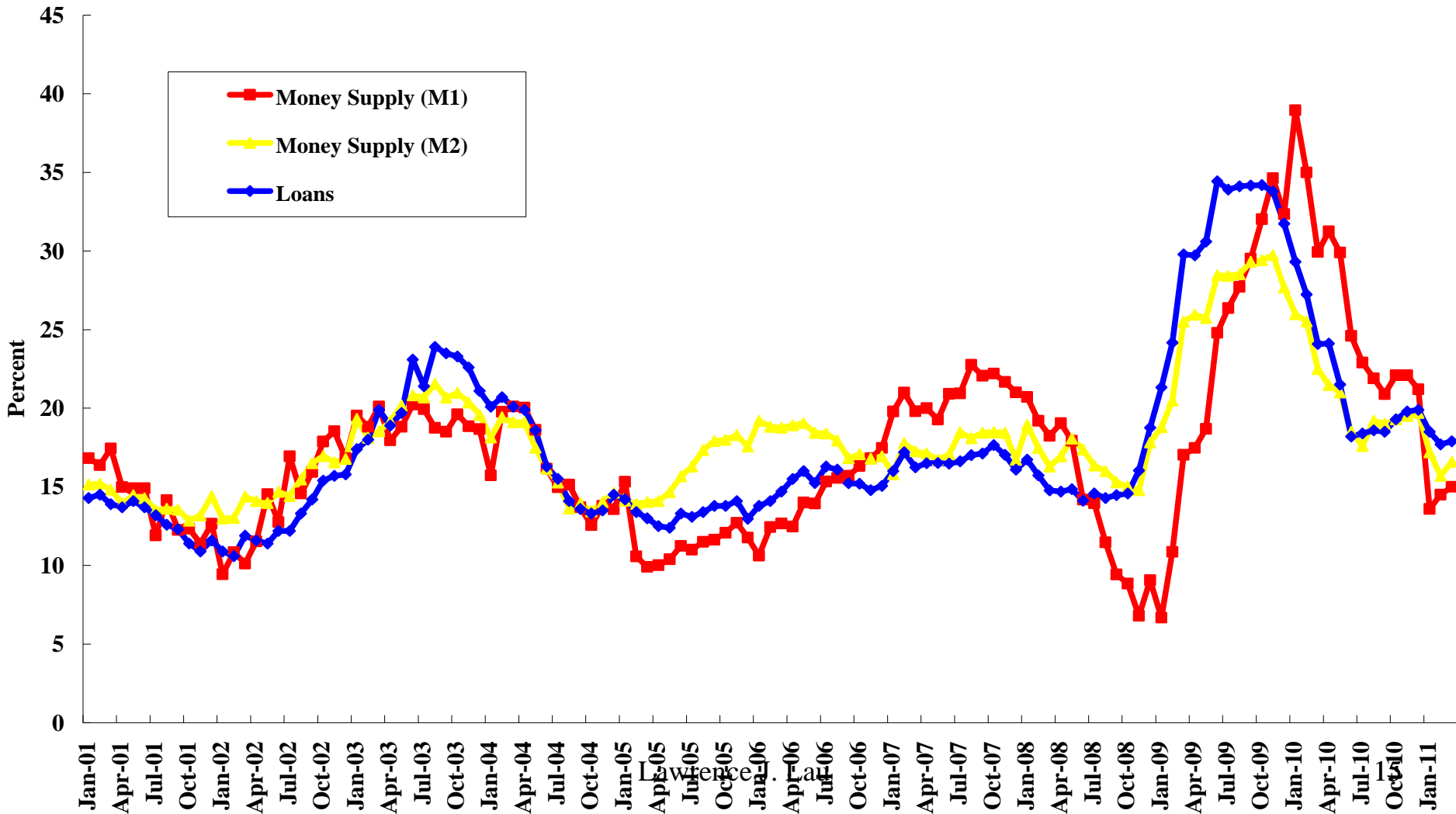
# Short-Term Deposit and Lending Rates and Bank Reserve Requirement

Short-Term Deposit and Lending Rates and Bank Reserve Requirement



# The Rates of Growth of Money Supply and Loans, Year-over-Year

The Rates of Growth of Money Supply and Loans, Year-over-Year



# The Macroeconomic Outlook

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- ◆ There is not much any central bank can do about agricultural prices. No head of a central bank anywhere in the World has been able to control the weather.
- ◆ The real concern is that the increases in asset prices will lead to increases in rents and hence in distribution and space costs, which can lead to price inflation of goods and services at the retail level. Such increases can in turn feed into inflationary expectations.



# The Macroeconomic Outlook

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- ◆ The key in reining in increases in asset prices, especially real estate prices, is to ensure that there is a continuing dependable and steady supply of the assets going forward. Only the expectation of dependable future supply availability can change price expectations.
- ◆ The Government must therefore try to create and maintain the expectation of regular increases of actual and potential supply through both its policy and its actual behaviour.
- ◆ Under the Twelfth Five-Year Plan (2011-2015), 36 million affordable housing units are supposed to be completed during the next five years.

# The Economic Fundamentals

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- ◆ Long-term economic growth of a country depends on the rates of growth of its primary inputs—capital (tangible or physical) and labour—and on technical progress (or equivalently the growth of total factor productivity)—that is, the ability to increase output without increasing inputs.
- ◆ The rate of growth of tangible or physical capital depends on the rate of investment on structure, equipment and basic infrastructure, which in turn depends on the availability of national savings.
- ◆ The rate of technical progress depends on investment in intangible capital (principally human capital and R&D capital).

# The Economic Fundamentals

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- ◆ The most important source of Chinese economic growth over the past three decades has been the growth of inputs, principally tangible capital (structures, equipment, and basic infrastructure) and not technical progress. The growth of tangible capital accounts for the bulk, approximately 80%, of the measured economic growth in China.
- ◆ This experience is not unlike those of other East Asian economies such as South Korea and Taiwan and even Japan and the United States at a similarly early stage of economic development.

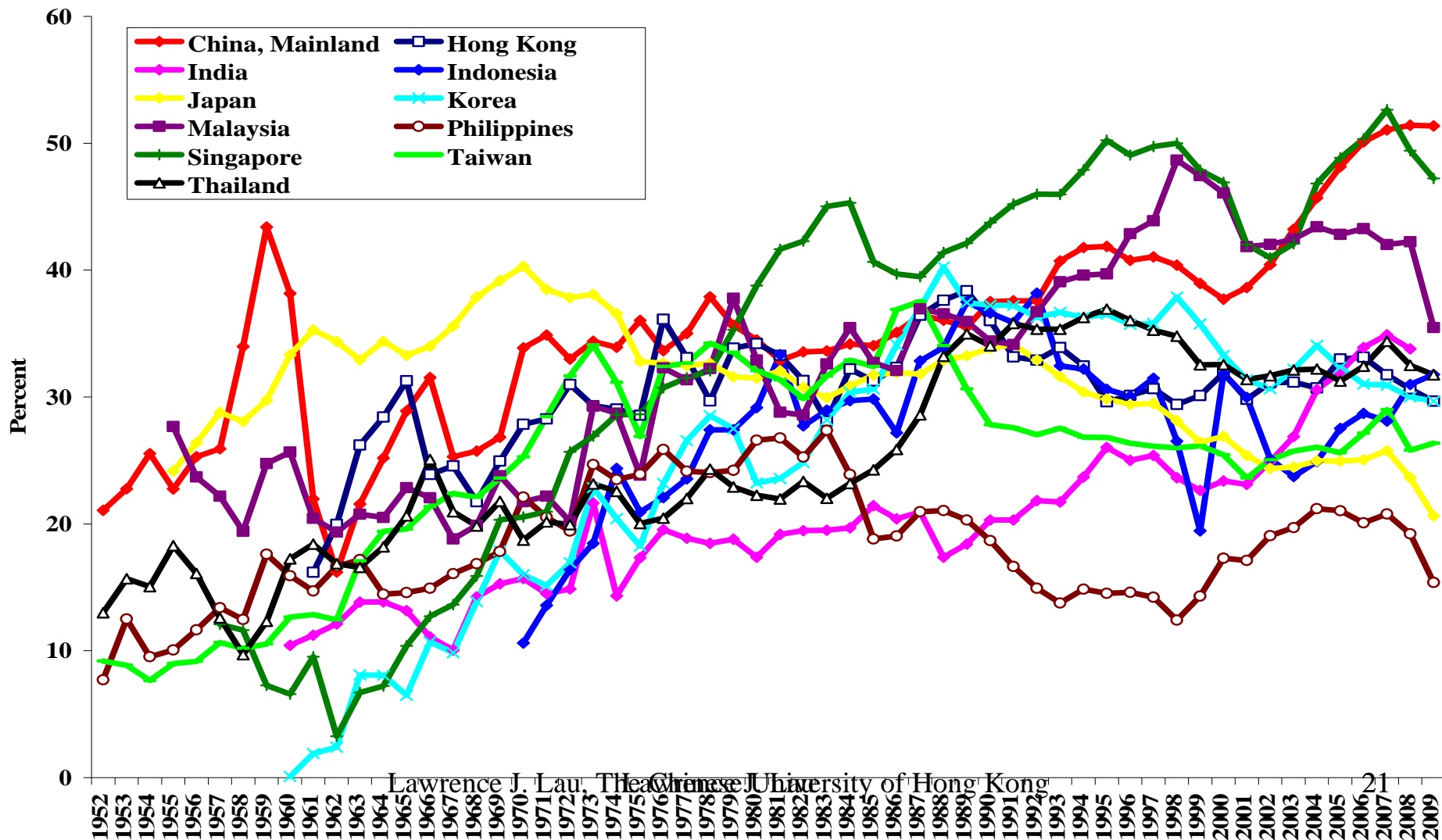
# The Economic Fundamentals

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- ◆ Chinese national savings rate has consistently been high--in excess of 30%--and in recent years has exceeded 40%, which is more than adequate to finance all of its domestic investment needs. It does not need to depend on foreign direct investment, foreign portfolio investment, or foreign loans.
- ◆ China has an almost unlimited supply of surplus labour, ensuring that there will be little or no pressure on the real wage rate of unskilled, entry-level labour for decades to come.

# Savings Rates of Selected Asian Economies (1952-present)

Savings Rates of Selected East Asian Economies



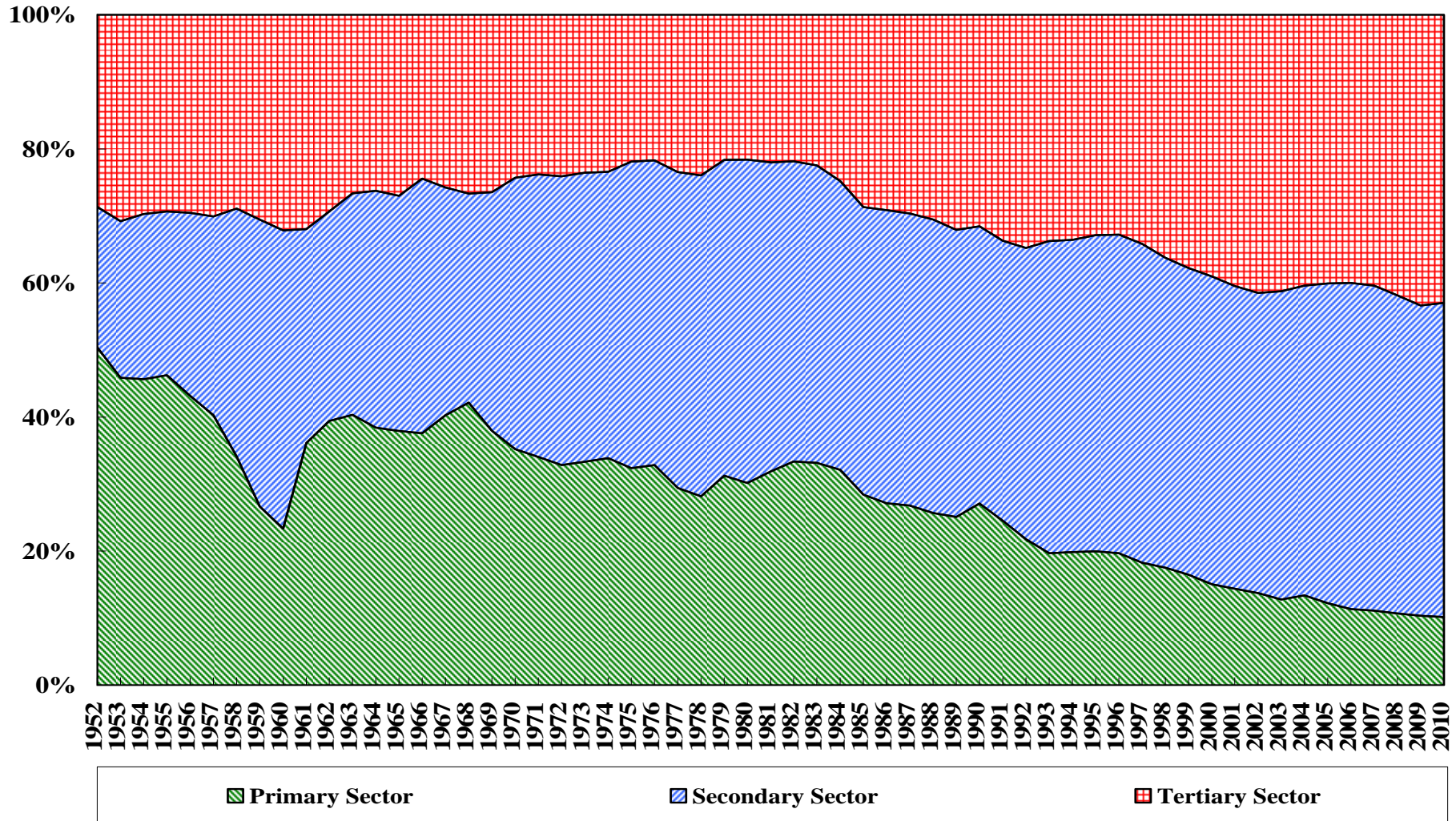
# The Economic Fundamentals

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- ◆ The distribution of Chinese GDP by originating sectors in 2009 was approximately: Primary (agriculture), 10.6%; Secondary (manufacturing, mining and construction), 46.8%; and Tertiary (services), 42.6%. (Note that mining is normally included in the primary sector in most other economies.)
- ◆ In 2010, the distribution has changed slightly to 10.2%, 46.9% and 43.0% respectively.

# The Distribution of Chinese GDP by Sector Since 1952

The Distribution of GDP by Sector



# The Economic Fundamentals

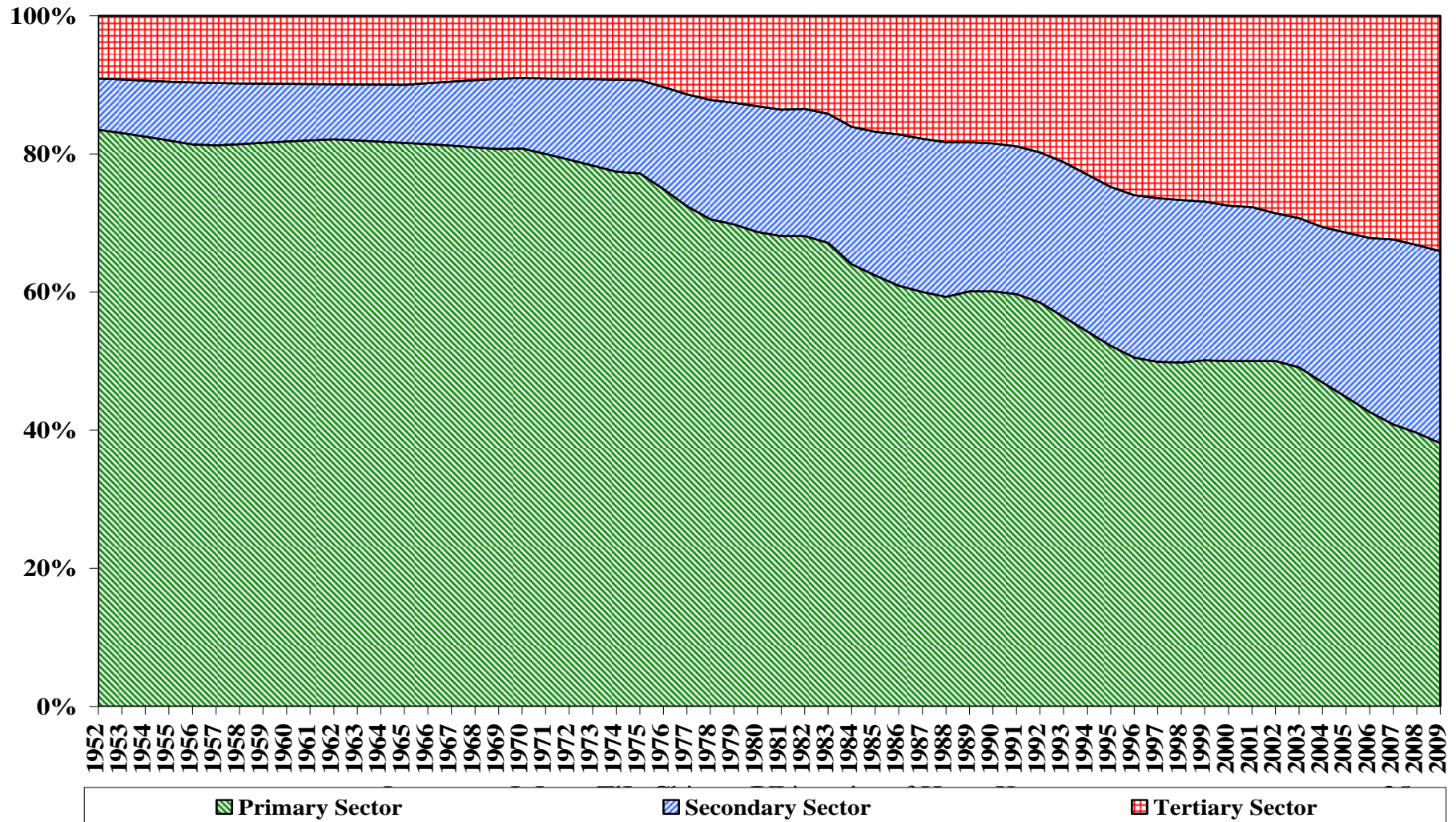
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- ◆ But the bulk of the labour force, more than 40%, is still employed in the primary sector, which in the case of China consists of only agriculture, waiting to be transferred to the other two sectors which have higher productivity.
- ◆ As long as the percentage of labour force employed in the primary sector significantly exceeds the percentage of GDP originating from the primary sector, there is little or no upward pressure on the real wage rate of unskilled, entry-level labour in the secondary and tertiary sectors.



# The Distribution of Chinese Employment by Sector Since 1952

The Distribution of Employment by Sector



# The Economic Fundamentals

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- ◆ The huge domestic market of 1.34 billion consumers allows economies of scale in production and in innovation to be easily realised in China.
- ◆ On intangible capital, China has a long tradition of emphasis on education and learning (human capital) and will be increasing its investment in human capital. The enrollment rate of tertiary education has been rising rapidly and stands at 24 percent today. It is expected to rise further over the next decades as private tertiary educational institutions become more numerous in response to demand and facilitated by government policy.
- ◆ China has also begun to increase its expenditure in Research and Development (R&D), with the goal of achieving 2.2 percent of GDP by 2015.

# The Twelfth Five-Year Plan for National Economic and Social Development

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- ◆ The Twelfth Five-Year Plan for National Economic and Social Development was approved by the National People's Congress in mid-March of this year. It is mostly an indicative plan rather than a mandatory plan.
- ◆ The most remarkable feature of the 12th Five-Year Plan was the lowering of the target growth rate from 7.5% per annum in the 11th Five-Year Plan to 7% per annum. It is almost certain that this target will be exceeded, just as the target was exceeded in the last Five-Year Plan. However, the reduction in the target growth rate signals the determination of the Chinese Government to de-emphasise quantitative economic growth and to focus on the quality of the economic growth.

# The Twelfth Five-Year Plan for National Economic and Social Development

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- ◆ The Plan provides for increased expenditures for education and healthcare, especially in the rural regions, environmental preservation and protection, and air and water pollution control. It also has mandatory targets for improvement in energy efficiency and reduction in carbon emission.
- ◆ It also provides for improvements in the income distribution through taxation, transfer payments and targeted government expenditures on education and health care.

# The Twelfth Five-Year Plan for National Economic and Social Development

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- ◆ A principal theme of the Twelfth Five-Year Plan is the transformation in the mode of Chinese economic development—first, from export-oriented to domestic demand-oriented and secondly, from input-driven to technical progress- or innovation-driven.
- ◆ The Plan also aims at essentially balanced international trade in goods and services, which I believe is achievable.

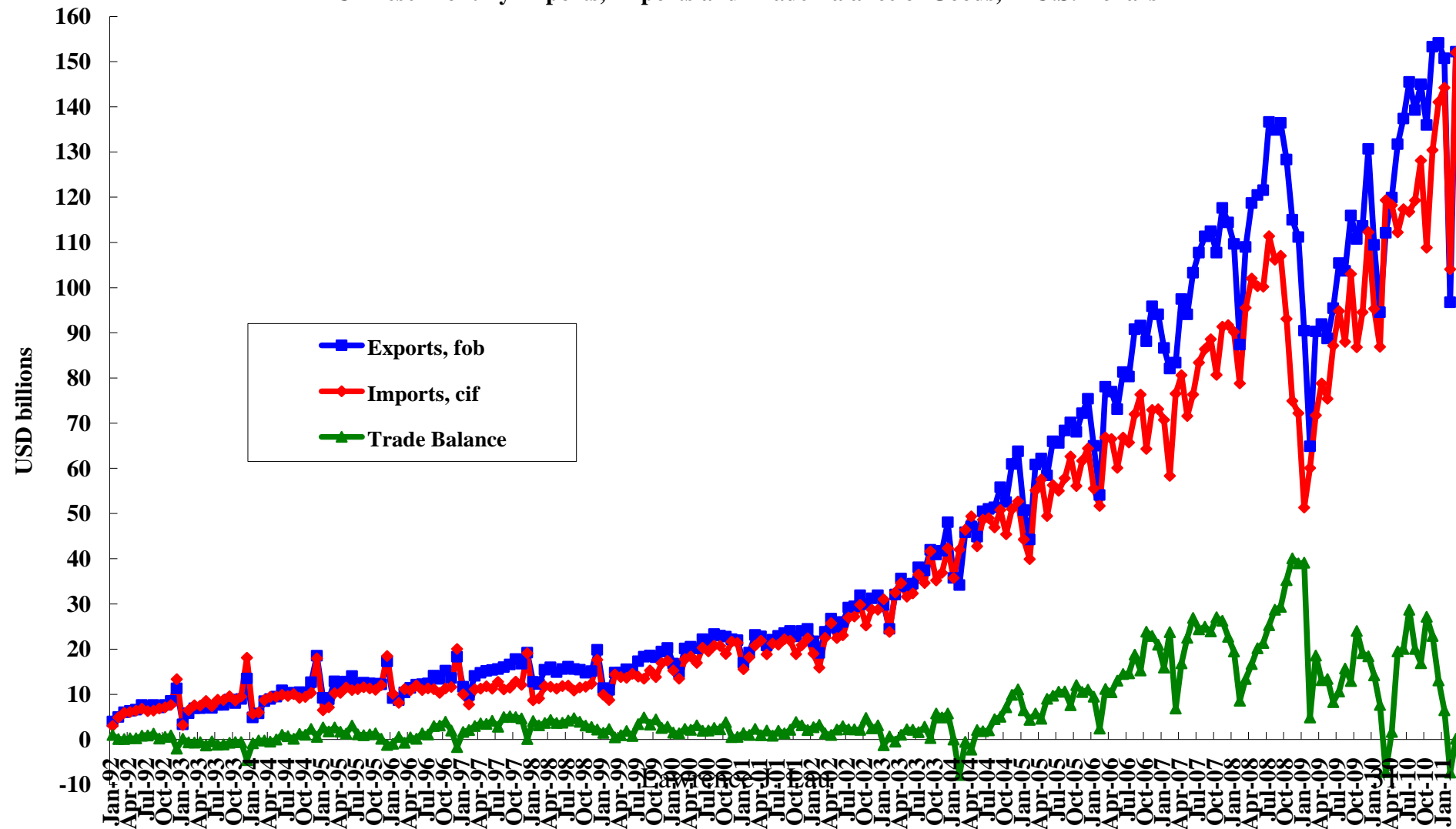
# Transformation of the Mode of Development

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- ◆ There is a common mis-impression that the Chinese economy is highly dependent on exports, and in particular, on its export surpluses, as a source of growth.
- ◆ The facts are that China only began to have a significant trade surplus vis-a-vis the World in 2005, whereas the Chinese economy has been growing at an average real rate of almost 10 percent per annum since 1978.
- ◆ It should therefore be clear that the trade surpluses could not have been an important source of growth for the Chinese economy during the past three decades. Chinese economic growth does not depend on Chinese trade surpluses.

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

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



# From Export-Oriented to Domestic Demand-Oriented

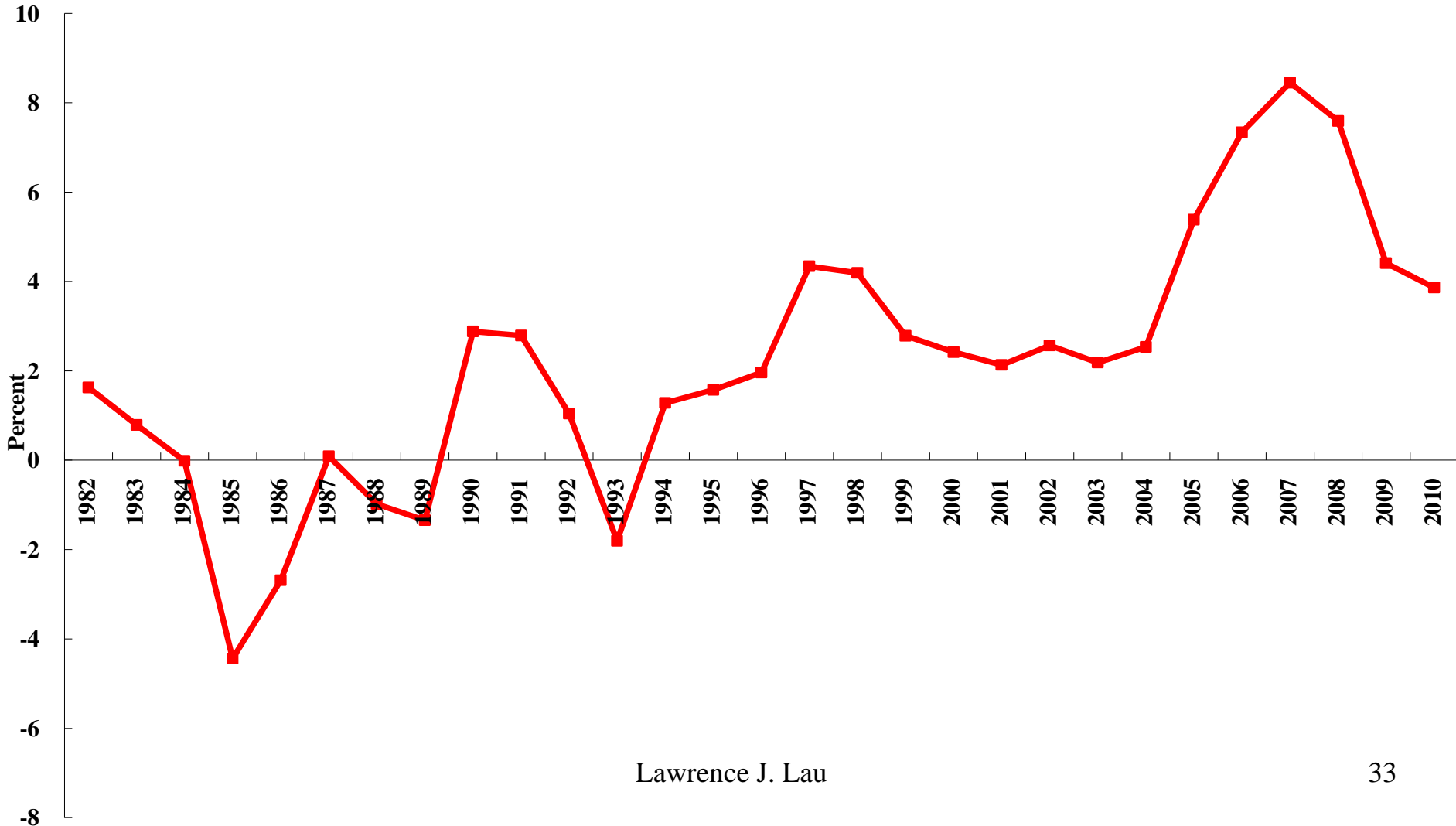
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- ◆ Chinese trade surplus as a percent of Chinese GDP fluctuated between -4.5 percent and 4.5 percent between 1982 and 2004 with an average of less than 2 percent of GDP. It then rose to a peak of almost 9 percent in 2007. It has since declined significantly and is less than 3 percent in 2010.
- ◆ Chinese international trade in goods and services vis-à-vis the whole world is expected to be essentially balanced in a couple of years, without necessarily any large adjustments in the Yuan/US\$ exchange rate.
- ◆ One reason that this is possible is the gradual closing of the savings-investment gap in China, as well as the substantial real appreciation of the Yuan versus the U.S.\$ that has occurred since mid-2005, to the tune of 25%.



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

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



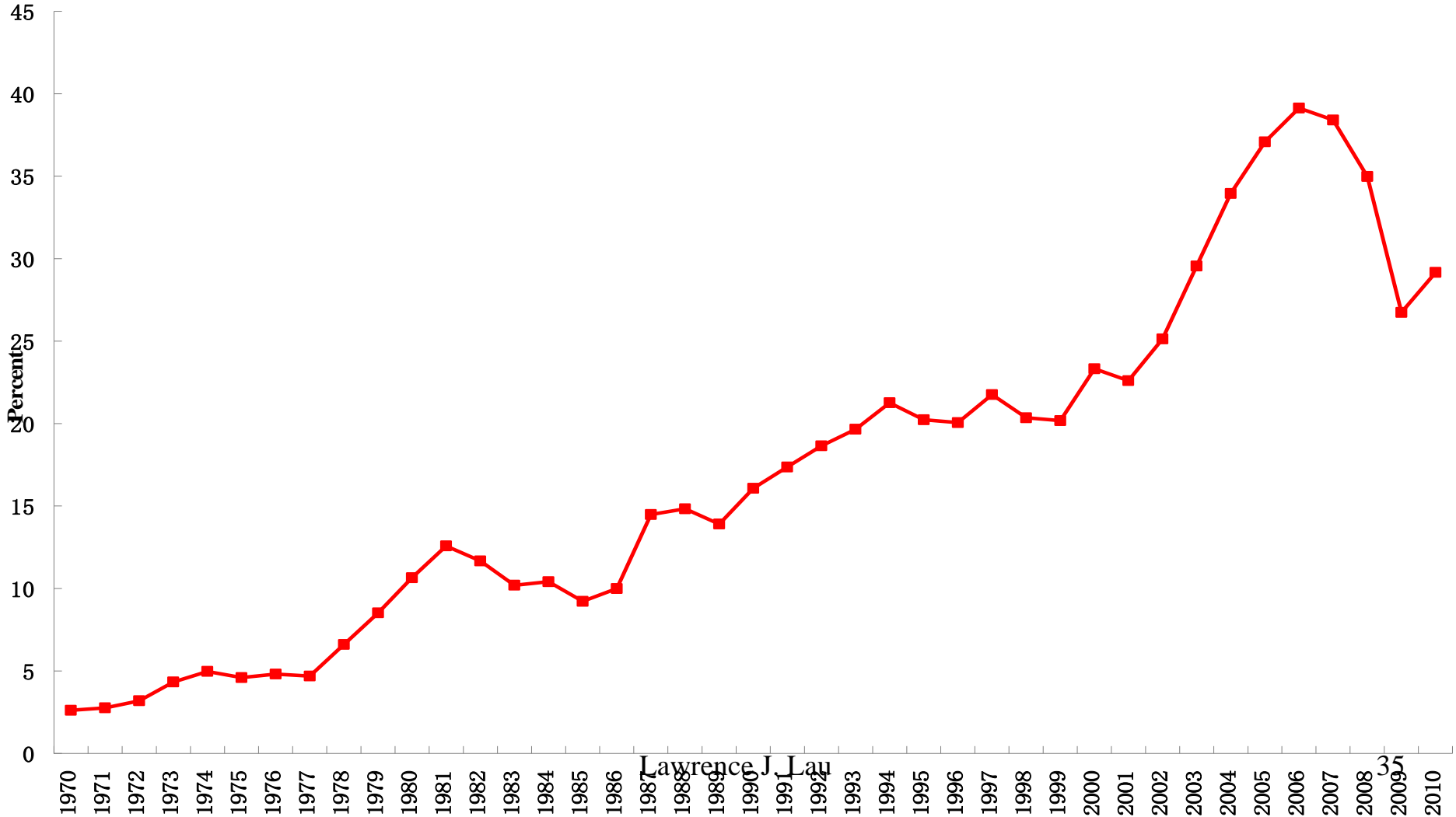
# From Export-Oriented to Domestic Demand-Oriented

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- ◆ 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 Percent of GDP, 1970-present

Chinese Exports of Goods and Services as a Ratio of GDP



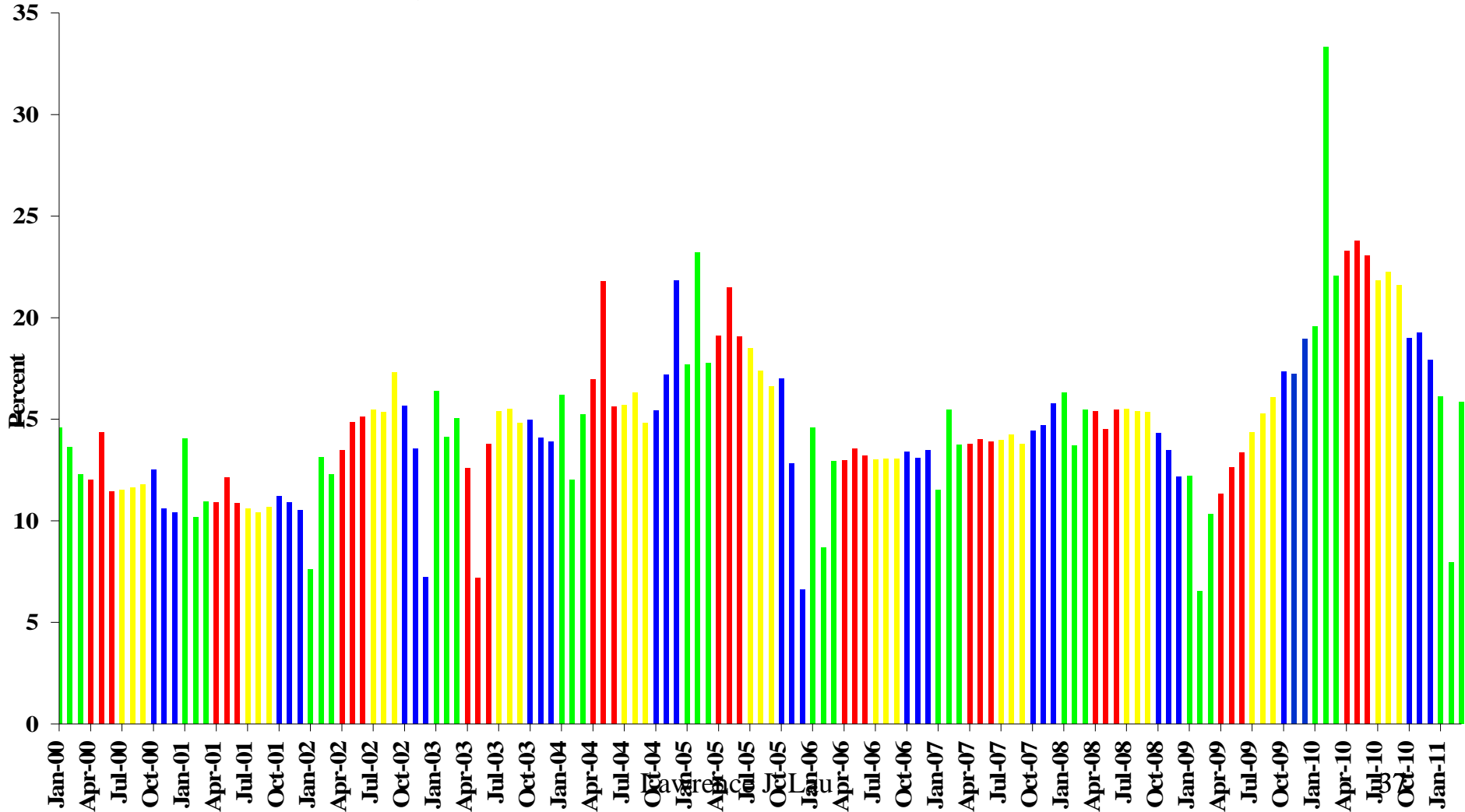
# From Export-Oriented to Domestic Demand-Oriented

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- ◆ Chinese household consumption is sometimes viewed as a potential sustainable source of growth of Chinese domestic aggregate demand. It has actually been growing quite rapidly, as indicated by the double-digit monthly year-over-year rates of growth of real retail sales since the first quarter of 2009.
- ◆ The rates of growth of real retail sales have far exceeded the rates of growth of real GDP or real household income during the same period, reflecting in part the lagged adjustment process of household consumption to increases in household income.
- ◆ Real rates of growth of consumption that are significantly higher than the rates of growth of real GDP may persist for a while if real household income continues to grow rapidly. But they are sustainable only if the share of household income in GDP, currently less than 50%, continues to increase.

# Monthly Rates of Growth of Chinese Real Retail Sales, Y-o-Y

Monthly Rates of Growth of Real Retail Sales since 2000, Year-over-Year



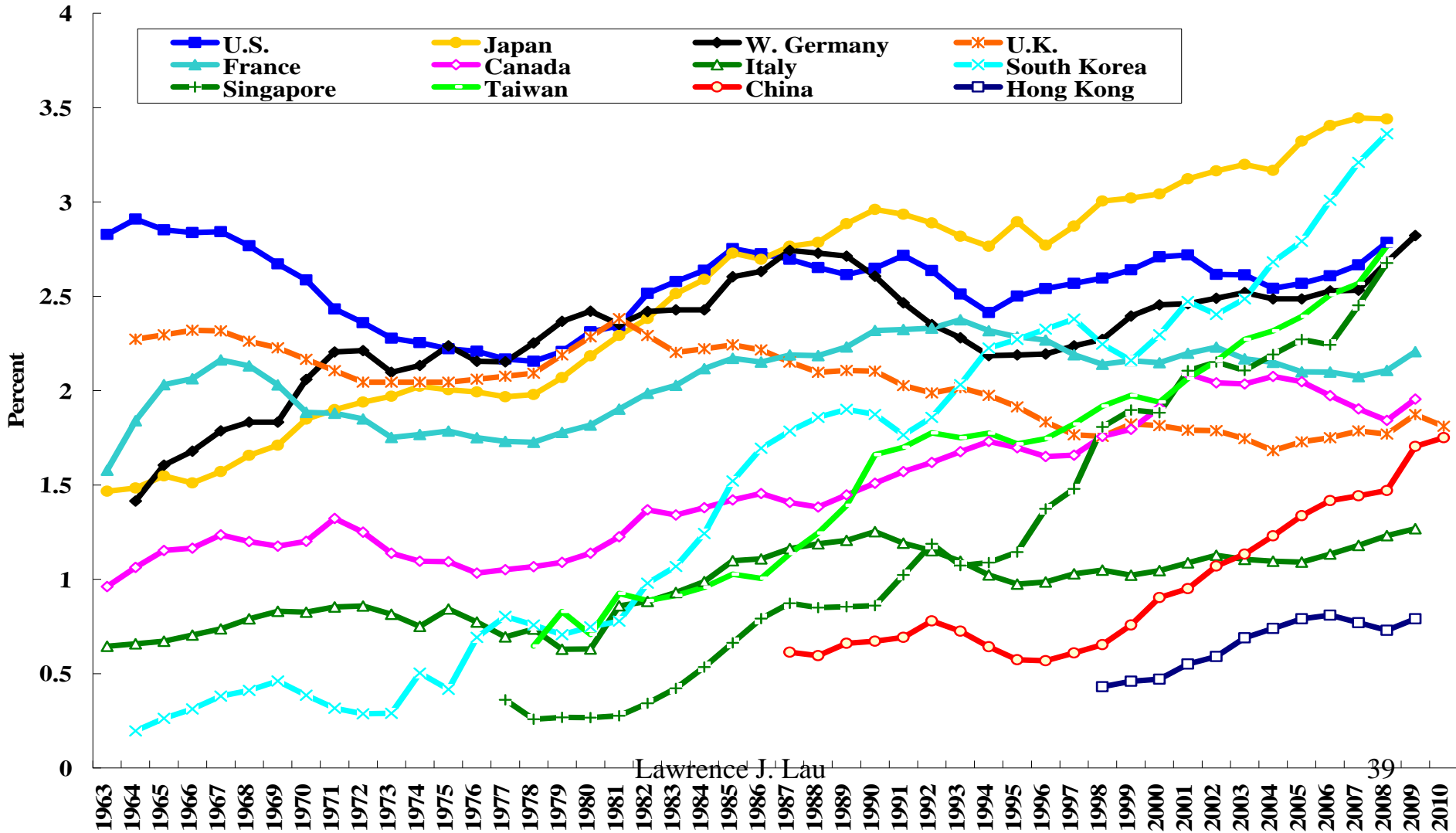
# From Input-Driven to Technical Progress-Driven

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- ◆ Sustained investment in R&D is essential for technical progress in an economy. China has also begun to invest heavily in R&D in recent years--R&D expenditure has been rising rapidly, both in absolute value, and as a percentage of GDP, but still lags behind the developed economies as well as the newly industrialised economies of East Asia.
- ◆ The Chinese R&D Expenditure/GDP ratio is targeted to reach 2.2% in 2015, still below the historical average for the U.S.
- ◆ By comparison, both Japan and South Korea invest more than 3% of their GDPs in R&D annually. The United States has on average invested approximately 2.5% of its GDP in R&D since the late 1950s.

# R&D Expenditures as a Ratio of GDP: G-7 Countries, 4 East Asian NIEs & China

Figure 8.1: R&D Expenditures as a Percentage of GDP: G-7 Countries, 4 East Asian NIEs and China



# The Internationalisation of the Renminbi

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- ◆ The Renminbi has been current accounts convertible since 1994. However, it has not become fully capital accounts convertible. There still exist both inbound and outbound capital controls in China. Some categories of capital movements require prior government approval. But individual Chinese citizens can remit up to US\$50,000 per person overseas each year, with few questions asked.



# The Renminbi as a Trade Settlement Currency

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- ◆ Chinese exporters and importers in selected regions have been permitted to settle their trade in Renminbi since 2009 on a voluntary basis. The practice has since been extended to the whole nation in 2011.
- ◆ Approximately 35% of Chinese trade is conducted with East Asian economies. If the Renminbi is to be used as the settlement currency by Chinese exporters and importers with their trading partners in East Asia, the Chinese demand for U.S. Dollars for international transactions purposes would be greatly reduced, and the People's Bank of China, China's Central Bank, would no longer need to hold as much foreign exchange reserves as it does now. 41

# The Renminbi as a Trade Settlement Currency

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- ◆ For comparison, approximately 25% of Japanese trade is denominated and settled in Yen.
- ◆ Chinese imports from East Asia except Japan amount to US\$300 billion a year. If these imports alone can be settled in Renminbi, the requirement of foreign exchange reserves for transaction purposes can be reduced by US\$300 billion.
- ◆ Similarly, Chinese exports to East Asia except Japan amount to more than US\$300 billion a year. To the extent that the importers in these East Asian economies can obtain Renminbi (for example, from their exporters), they may also be able and willing to pay for their imports from China in Renminbi.
- ◆ If this happens, the US\$ assets held in the foreign exchange reserves of their central banks for transactions purposes can also be reduced.

# The Renminbi as a Trade Settlement Currency

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- ◆ The proportion of Chinese trade settled in Renminbi, on an entirely voluntary basis, has grown from 0.5% in 2010 to 7% as of the end of 2011Q1. This proportion is expected to increase further in the future.
- ◆ Thus far, trade settlement in Renminbi is predominantly for Chinese imports, accounting for 89%. In order for Renminbi settlement to be more widely used by Chinese exporters, overseas importers must be able to have access to Renminbi themselves. This will take time and may be facilitated by a forward market for Renminbi with participation restricted to bona fide exporters to and importers from China.

# The Renminbi as a Trade Settlement Currency

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- ◆ Moreover, if other East Asian economies, such as Hong Kong, Indonesia, South Korea, Malaysia and Thailand also use the Renminbi as their settlement currency for trade amongst themselves, it would further reduce the demand for U.S. Dollars for international transactions purposes and hence the proportion of the foreign exchange reserves that the central banks of these economies hold in terms of U.S. Dollar-denominated assets. However, it may also increase demand of these central banks for Renminbi-denominated assets to be held as part of their foreign exchange reserves.

# The Renminbi as a Trade Settlement Currency

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- ◆ Recently, the Ministers of Finance of China, Japan and South Korea, meeting on the sidelines of the Asian Development Bank annual meeting in Hanoi, issued a statement to the effect that they would study the use of their own currencies in trade settlement with one another.
- ◆ Trade settlement in the own currencies of the trading partner-countries is straightforward if the bilateral trade is basically balanced. A problem arises only when there are persistent surpluses or deficits. The central bank of the surplus country will wind up holding the currency of the deficit country. What can be done to reassure the surplus country that it will not lose out by holding the currency of the deficit country for more than a short term?

# The Renminbi as a Trade Settlement Currency

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- ◆ A commitment by the central bank of a country through mutual agreements to redeem its currency held by other central banks in terms of other hard currencies, gold, or its inflation-indexed bonds will go a long way to reassure the central banks of surplus countries that they will not lose out in terms of purchasing power, which is ultimately what really matters.
- ◆ If such arrangements turn out to be widespread and durable, they may supplant the use of the U.S. Dollar as the principal international trade settlement currency eventually.

# Renminbi as an International Reserve Currency

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- ◆ Even if the Renminbi is not fully convertible in the sense of a total absence of inbound as well as outbound capital controls, it may nevertheless be maintained as part of foreign exchange reserves by the central banks and monetary authorities of other countries and regions as long as there is a credible commitment through mutual agreement by the People's Bank of China to convert any Renminbi presented by a foreign central banks into U.S. Dollars or Euros or any other so-called “hard” currencies, or even gold at a pre-agreed parity. Foreign central banks can hold the Renminbi for potential transactions purposes with China or other economies willing to accept the Renminbi.

# Renminbi as an International Reserve Currency

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- ◆ The People's Bank of China already has bilateral currency swap agreements in place with the central banks or monetary authorities of Argentina, Belarus, Hong Kong, Indonesia, South Korea, Malaysia and Mongolia and more such agreements are expected to come.



# Renminbi as an International Reserve Currency

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- ◆ Whether the Renminbi will become a major international reserve currency eventually remains to be seen. There are both pros and cons for a country's currency to be used by other countries as an international reserve currency.
- ◆ The Japanese Yen is fully convertible but the Japanese Government has not promoted its use by other countries as a major international reserve currency.
- ◆ At the present time, Hong Kong, Singapore and South Korea have all been considering investing part of their foreign exchange reserves in Yuan-denominated securities to diversify its portfolio, even though the Yuan (Renminbi) is not yet fully convertible.

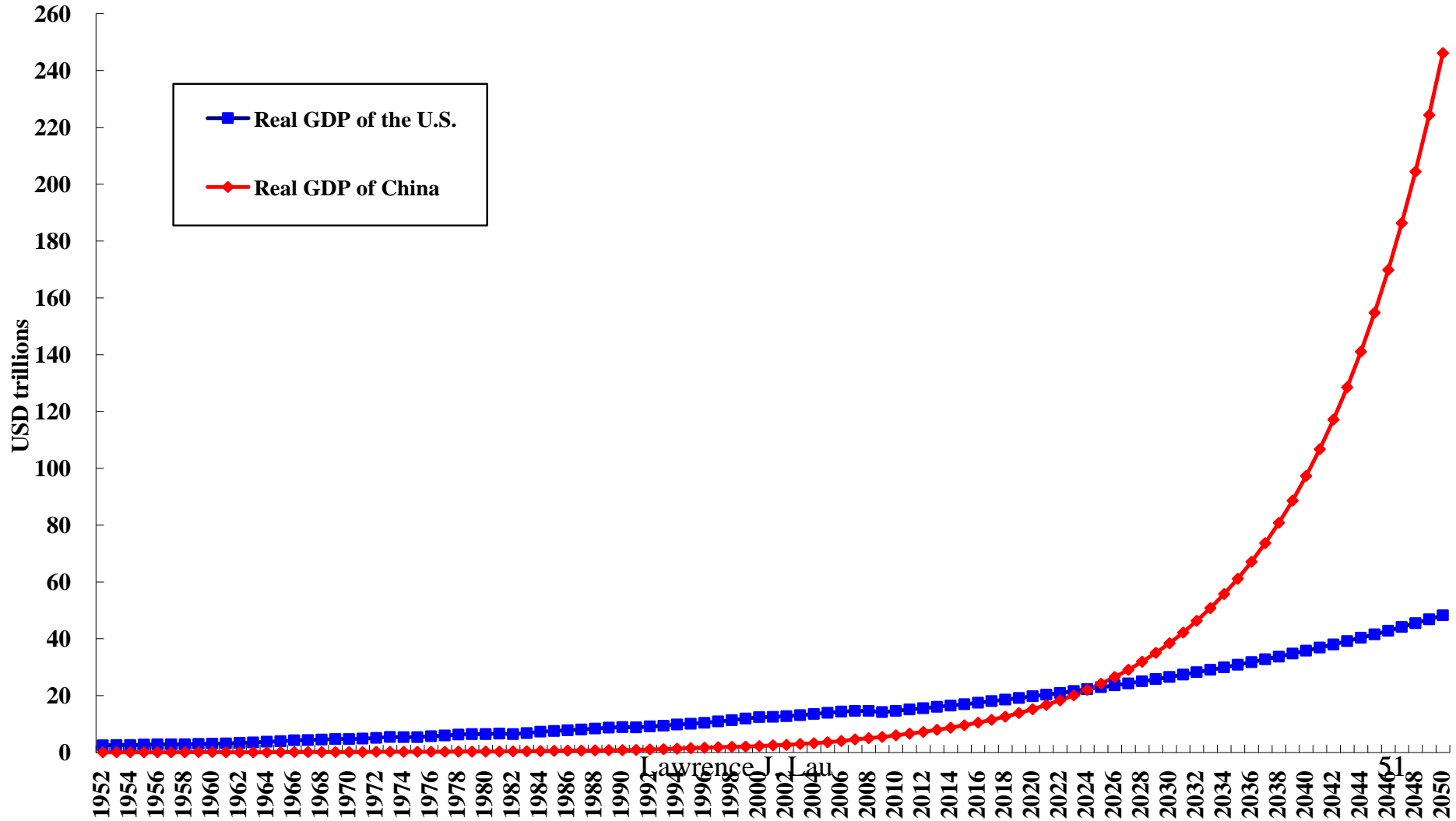
# Projections of the Future

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- ◆ If current trends continue, Chinese real GDP will approach the level of U.S. real GDP in approximately 15 years' time-around 2025, at which time Chinese real GDP will exceed US\$20 trillion (in 2010 prices) and Chinese real GDP per capita will exceed US\$ 14,000.
- ◆ By that time, 2025, China and the U.S. will each account for approximately 15% of World GDP.

# Actual and Projected Chinese and U.S. Real GDP (trillion 2010 US\$)

Actual and Projected Real GDP of China and the U.S., in 2010 prices



# Concluding Remarks

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- ◆ Given its economic fundamentals, the Chinese economy will be able to continue to grow rapidly over the next couple of decades, at an average rate of between 7% and 8% per annum.
- ◆ In the long run, the sources of sustainable Chinese aggregate demand will be internal: household and public consumption, investment in infrastructure (including high-speed inter-urban trains), urbanisation (building new cities including urban mass-transit systems), investment in owner-occupied residential housing, investment in education and health care, environmental protection and preservation, energy conservation and renewable energy.<sup>52</sup>

# Concluding Remarks

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- ◆ Consumption will rise, as GDP per capita and the real wage rate rise and the social safety net is gradually perfected. But the national savings rate will remain high for a long time.
- ◆ Exports as a share of Chinese GDP will probably continue to decline over time, as befitting a large, continental economy. 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 even prolonged economic recessions in the European and U.S. economies.

# Concluding Remarks

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- ◆ The Renminbi will be used more and more in the settlement of Chinese international trade with East Asian economies and perhaps even in the settlement of trade among East Asian economies.
- ◆ For 2011, the short-term economic targets of the Chinese Government are to achieve a real rate of growth of 8 percent and a rate of inflation of 4 percent. I am confident that both targets are achievable.