Chinese Economic Development Trends

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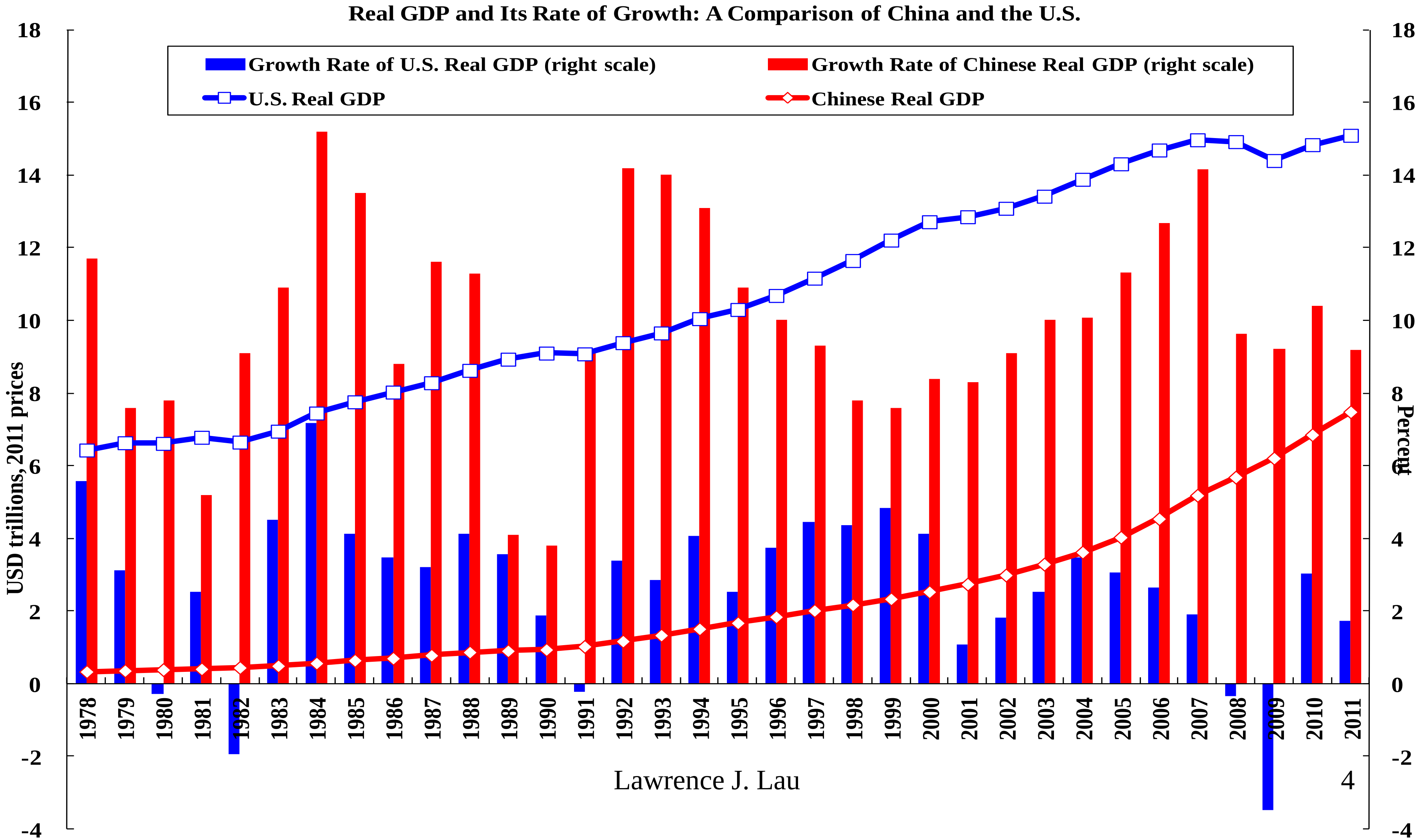
Introduction

- 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 9.8% per annum over the past 34 years. It is historically unprecedented for an economy to grow at such a high rate over such a long period of time.
- Between 1978 and 2011, Chinese real GDP grew almost 22 times, from US$333 billion to nearly US$7.5 trillion (2011 prices) to become the second largest economy in the World, after the U.S.
- By comparison, the U.S. GDP (approx. US$15.1 trillion) was 2 times Chinese GDP in 2011.

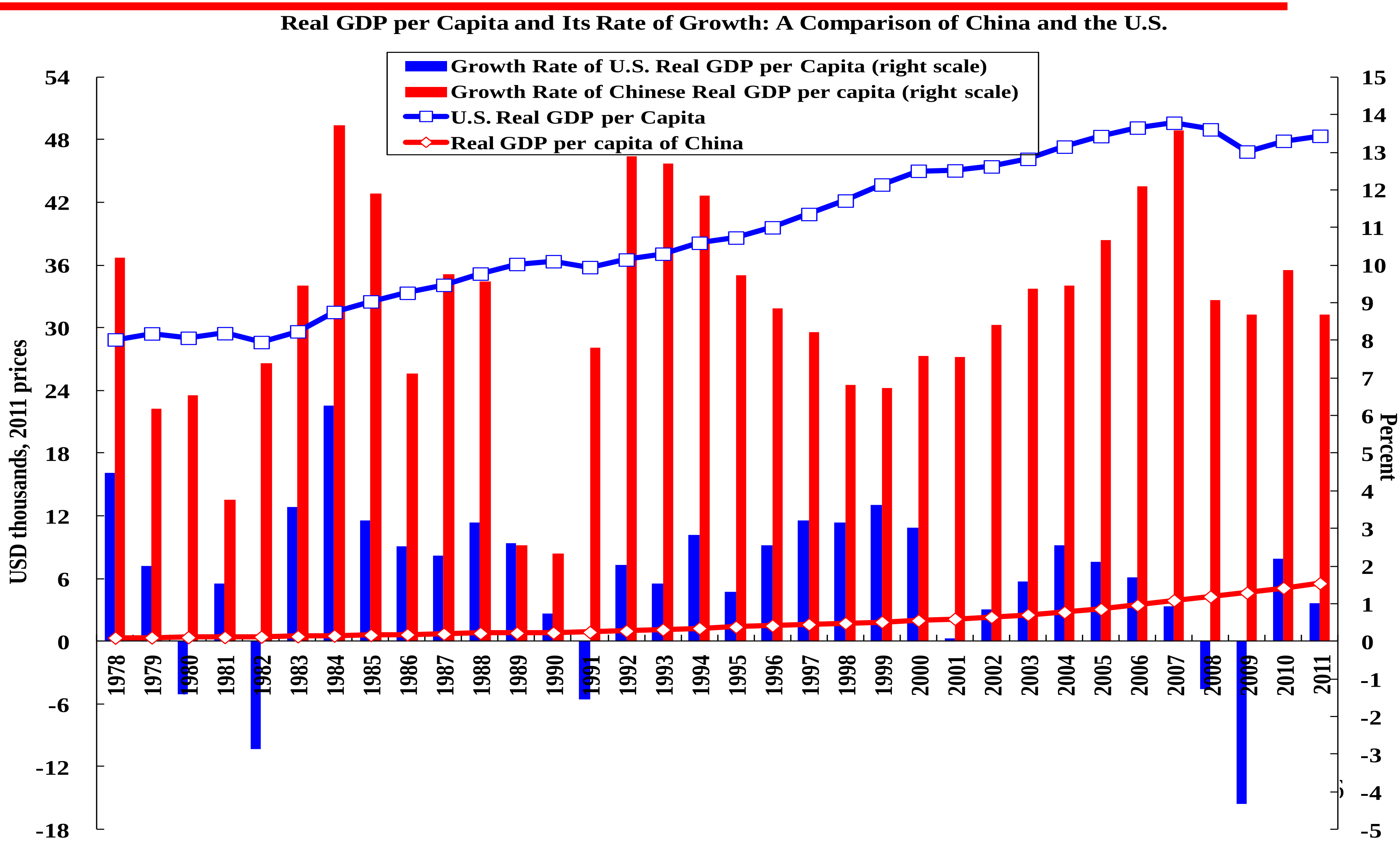
Real GDP and Its Rate of Growth: A Comparison of China and the U.S. (2011$)



Introduction

- Despite its rapid growth, in terms of its real GDP per capita, China is still a developing economy.
- Between 1978 and 2011, Chinese real GDP per capita grew 15 times, from US$346 to US$5,555 (in 2011 prices).
- By comparison, the U.S. GDP per capita of approximately US$48,236, was 8.7 times Chinese GDP per capita in 2011.

Real Chinese and U.S. GDP per Capita in US$ Since 1952 (2011 Prices)



Introduction

- 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.

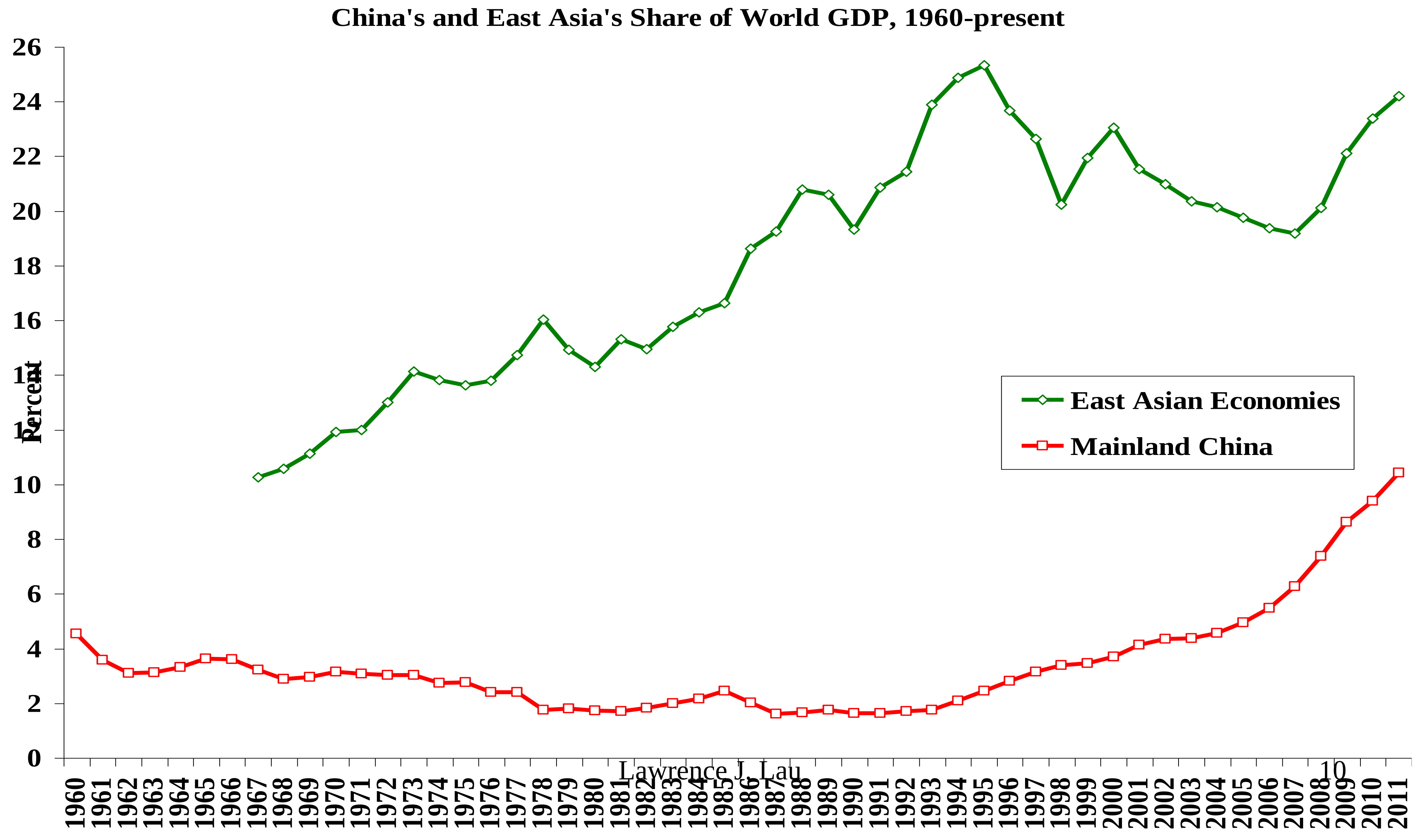
Introduction

- The Chinese Government leaders have also amply demonstrated their ability to confront important challenges and solve difficult problems over the past 34 years, surviving various economic and financial crises such as the 1997-1998 East Asian currency crisis, the 2007-2009 global financial crisis and the more recent European sovereign debt crisis.
- China is one of the very few socialist countries that have made a smooth transition from a centrally planned to a market economy. It is a model for other transition economies such as Vietnam and potential transition economies such as Cuba, Laos, and North Korea.

The Shifting Centre of Gravity of the World Economy

- Through the past three decades, the centre of gravity of the World economy has been gradually shifting from the United States and Europe to Asia, including both East Asia and South Asia.
- The East Asian economies have become partially de-coupled from the rest of the World economy, as evidenced by the strong performance of China, India and other East Asian economies during the 2007-2009 global financial crisis as well as the current European sovereign debt crisis.
- However, the Chinese and East Asian economies are not large enough to turn the World around. The idea of a G-2 group of countries consisting of only China and the United States leading the World economy is premature.

China and East Asia's Share of World GDP, 1960-present (Current Prices)



The Economic Fundamentals

- The quantity of output of an economy depends on the quantities of inputs, as well as the efficiency with which inputs are transformed into output, in other words, the ability to increase output without increasing inputs.
- Long-term economic growth of a country therefore depends on the rates of growth of its primary inputs—(tangible or physical) capital and labour—and on human capital and technical progress (also known as the growth of total factor productivity), that is, the ability to increase the efficiency with which inputs are transformed into output.

The Economic Fundamentals

- The rate of growth of tangible 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

- The most important source of Chinese economic growth since 1978 has been the growth of inputs, principally tangible capital (structures, equipment, and basic infrastructure) and not technical progress. This experience is not unlike those of other East Asian economies such as South Korea and Taiwan and even Japan at a similarly early stage of economic development.
- The growth of tangible capital accounts for the bulk (more than 80%) of the measured economic growth in China. The tangible capital stock has been growing at approximately 15% per year.
- However, unlike the experience of the other East Asian economies, economies of scale have also played an important role in Chinese economic growth because of the huge size of the Chinese domestic market.

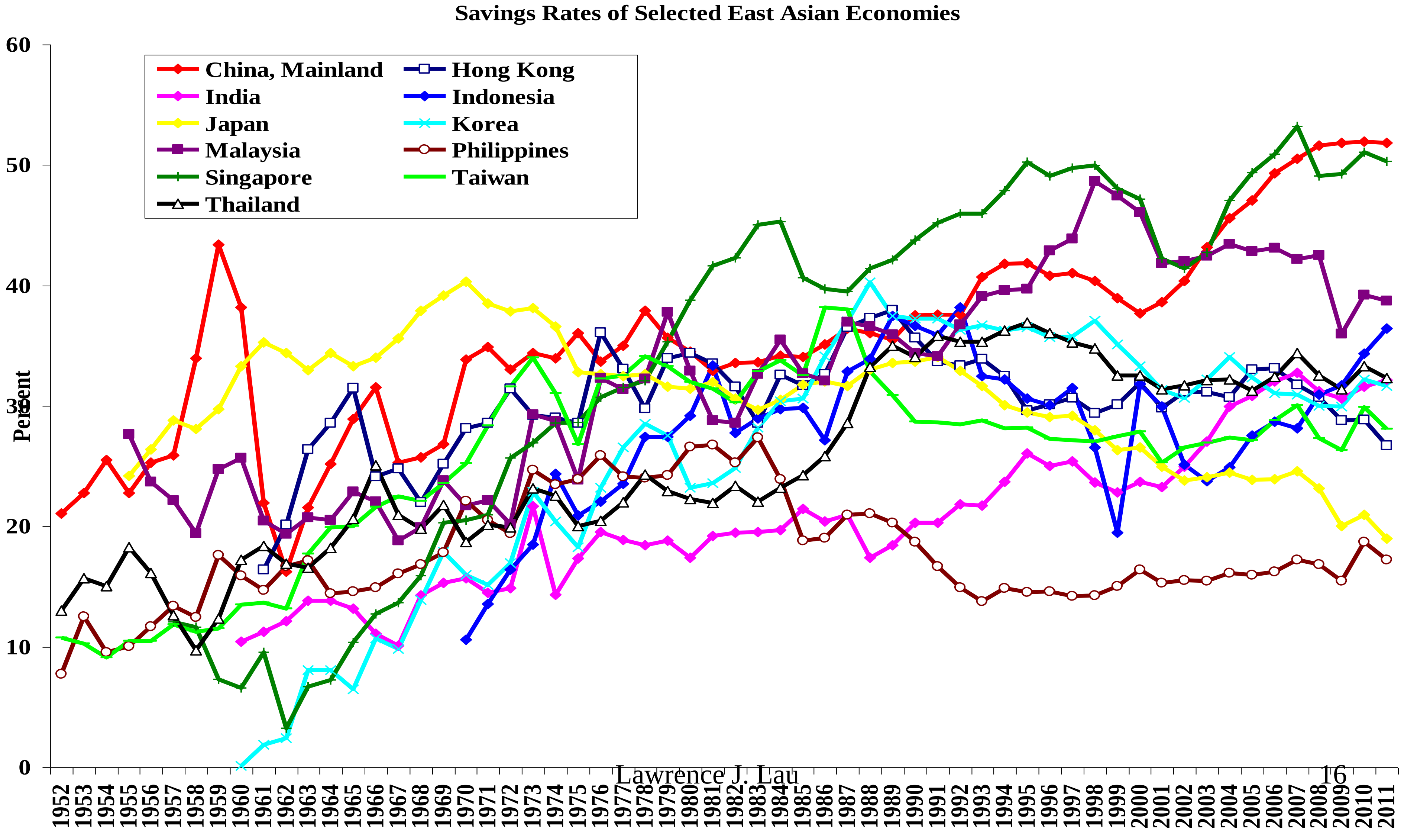
The Economic Fundamentals

- Chinese economic growth since 1978 has been underpinned by three factors:
- (1) A consistently high national savings rate on the order of 30% and above except for a brief start-up period. It has stayed around 40% since the early 1990s and has at times approached or even exceeded 50% in more recent years. This means, among other things, that the Chinese economy can finance all of its domestic investment needs from its own domestic savings alone, thus assuring a high rate of growth of the tangible capital stock without having to depend on the more fickle foreign capital inflows (including foreign portfolio investment, foreign direct investment or foreign loans).

The Economic Fundamentals

- (2) An unlimited supply of surplus labour—there is no shortage of and no upward pressure on the real wage rate of unskilled, entry-level labour. And
- (3) A huge domestic market of 1.34 billion consumers with pent-up demand for housing and transportation and other consumer goods and services (e.g., education and health care), enabling the realisation of significant economies of scale in production and in investment in intangible capital, including innovation and goodwill (e.g., brand building), based entirely on domestic demand. This is an advantage not available to the other East Asian economies.

Savings Rates of Selected Asian Economies (1952-present)



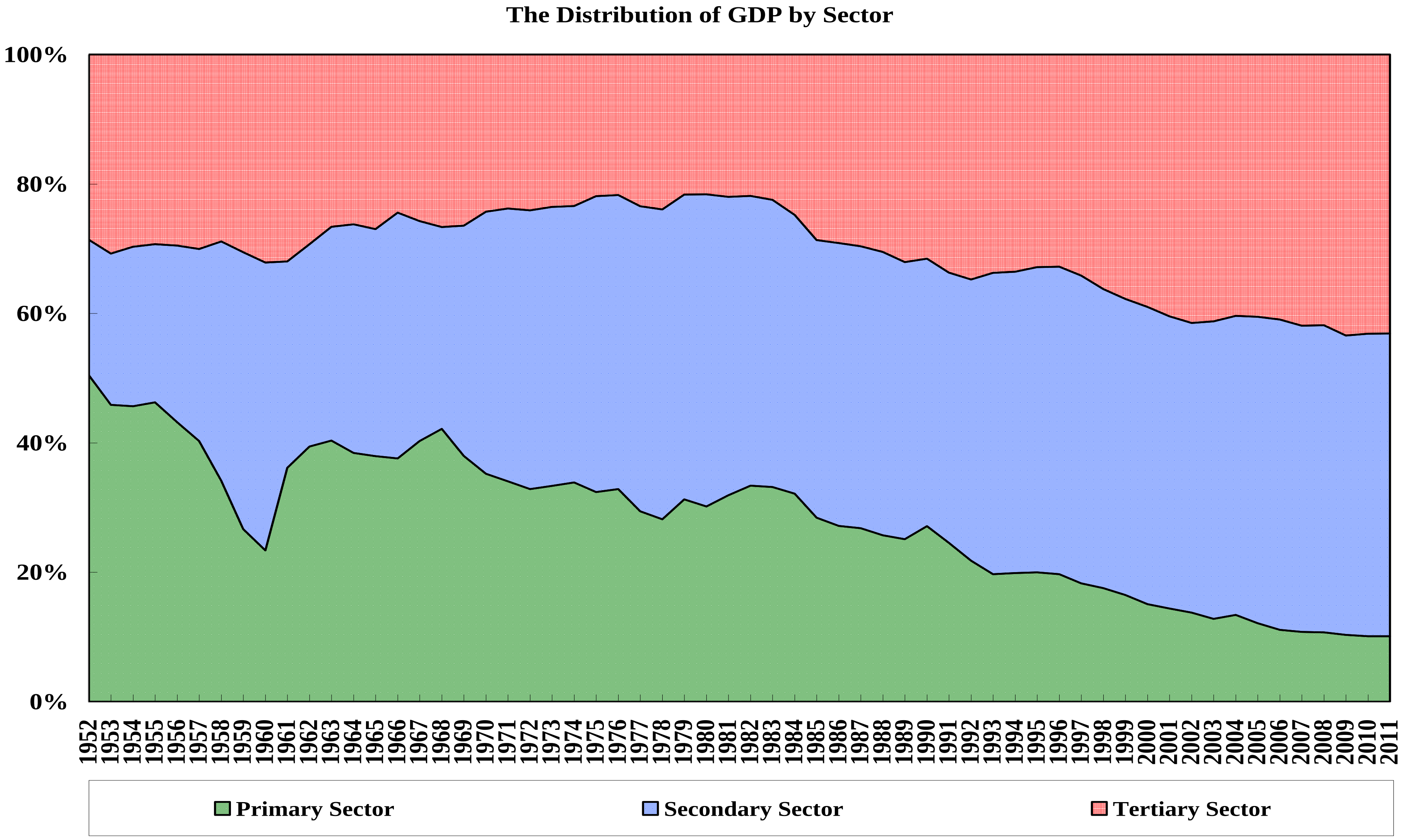
The Economic Fundamentals

- China, like Japan, Taiwan, and South Korea in their early stages of economic development, has an abundant supply of surplus labour. This means China can grow without being constrained by the supply of labour or by rising real wage rates of unskilled, entry-level labour over an extended period of time.
- Investment in physical capital is very productive under conditions of surplus labour and as long as there is sufficient complementary domestic physical capital, the surplus labour will enable the output of the economy to grow rapidly.
- This is exactly what the late Prof. W. Arthur Lewis, Nobel Laureate in Economic Sciences, said in his famous paper on surplus labour more than fifty years ago.

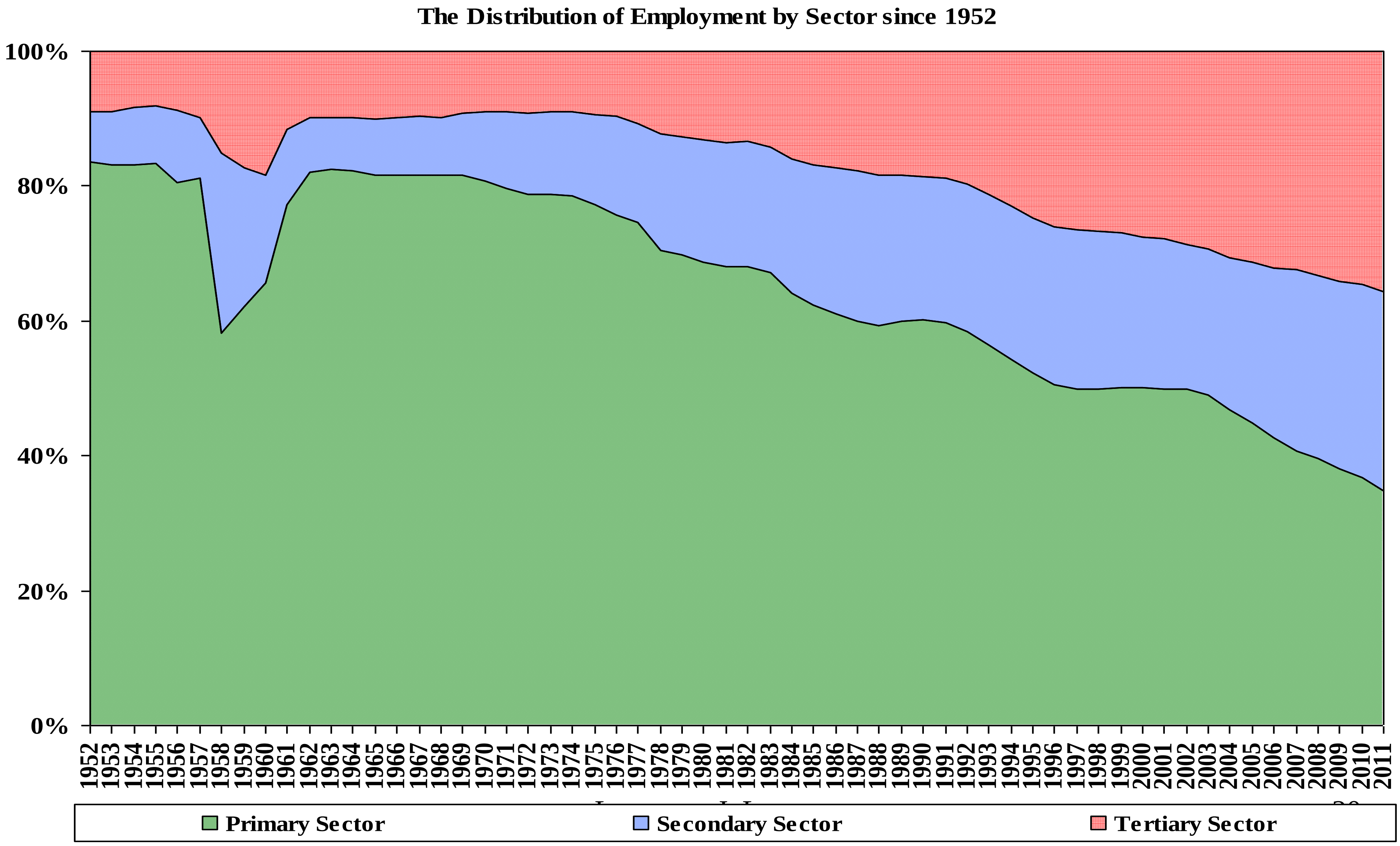
The Economic Fundamentals

- The distribution of Chinese GDP by originating sectors in 2011 was approximately: Primary (agriculture), 10.1%; Secondary (manufacturing, mining and construction), 46.8%; and Tertiary (services), 43.1%. (Note that mining is normally included in the primary sector in most other economies.)
- But the bulk of the labour force, more than 36%, 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 productivities.
- 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 GDP by Sector Since 1952



The Distribution of Chinese Employment by Sector Since 1952



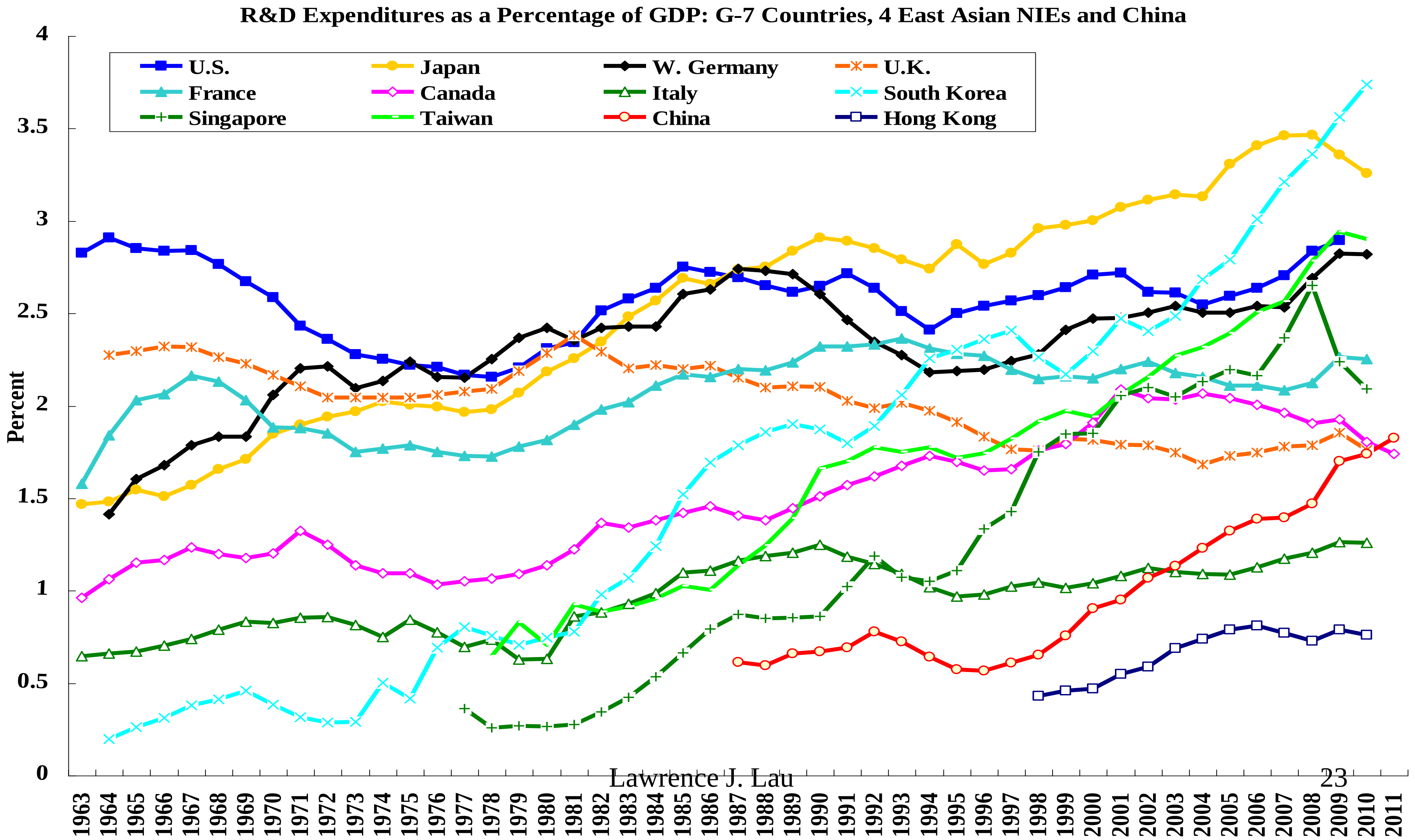
The Economic Fundamentals

- It took 33 years for the percentage of labour force employed in the Chinese primary sector to decline from 70.5% in 1978 to 36.7% in 2011, at the rate of approximately 1 percentage point per year.
- It will take approximately another 25 years or so for the percentage of labour force employed in the Chinese primary sector to decline from 36.7% to below 10%, which is approximately the same as the percentage of Chinese GDP produced by the primary sector today. By that time, it is expected that the primary sector will account for no more than 5% of Chinese GDP.
- China will therefore continue to have surplus labour for another two or three decades. During this period, there will not be any shortage of unskilled, entry-level labour, even though there may be shortages of skilled or experienced labour in the secondary and tertiary sectors.

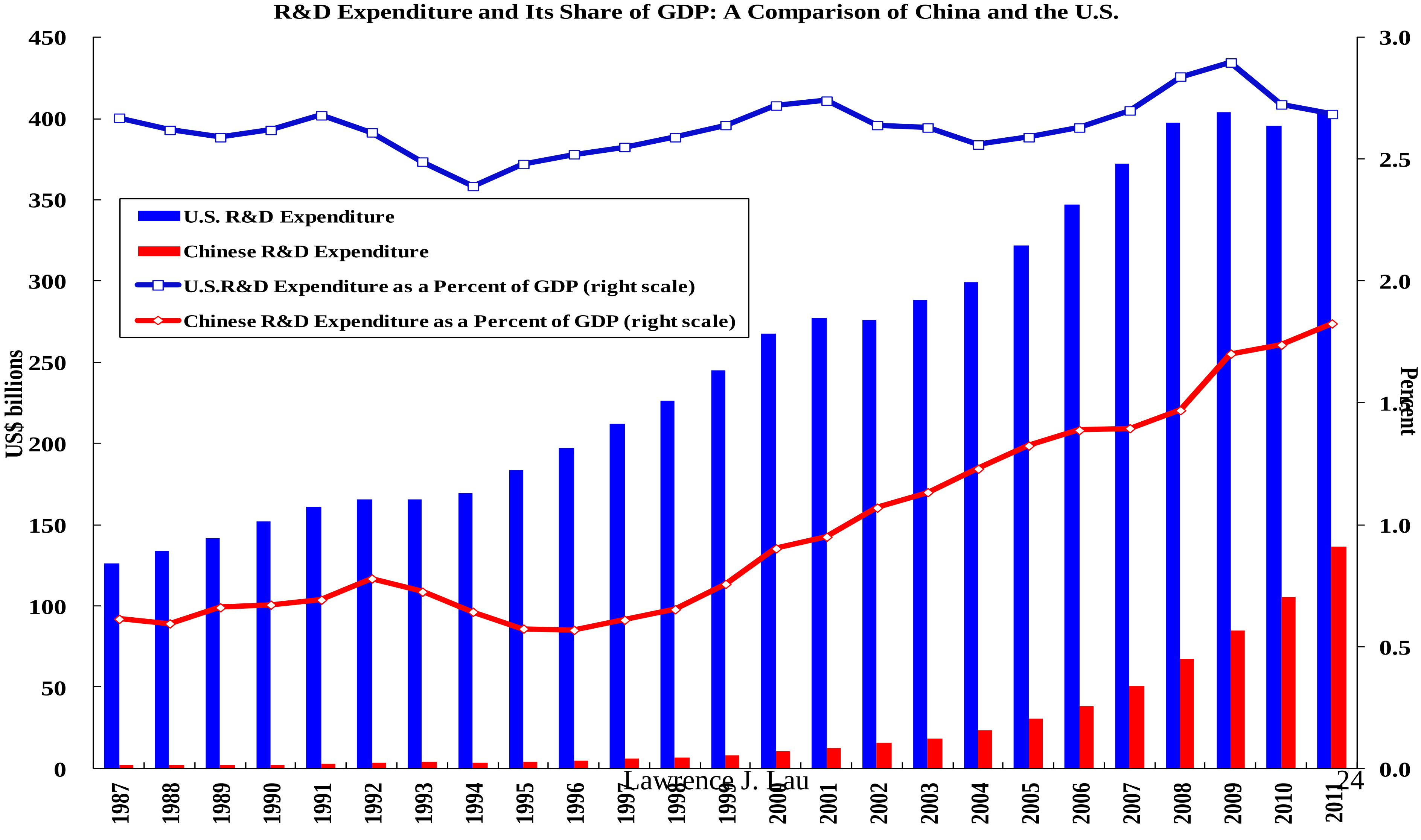
The Economic Fundamentals

- Sustained investment in research and development (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 of 2.5% for the U.S.)
- By comparison, both Japan and South Korea invest more than 3% of their GDPs in R&D annually.

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



R&D Expenditure and Its Share of GDP: A Comparison of China and the U.S.



The Economic Fundamentals

- The huge potential domestic market of 1.34 billion consumers not only enables the realisation of economies of scale but also greatly enhances the productivity of intangible capital (e.g., R&D capital, goodwill). The fixed research and development costs of a new product or process can be easily amortised over a large market. The benefits of investment in goodwill, e.g., brand-building, are also much greater in a large market.
- The huge potential domestic market also enables active Chinese participation in the setting of product and technology standards and sharing the benefits of such standard-setting.

The Economic Fundamentals

- Brand-building is a pre-requisite for Chinese enterprises to re-orient themselves to take advantage of the huge domestic market. It is true that brand-building requires resources, but it also enables the owners of brand names to have much more pricing power and higher profit margins than enterprises that do only OEM (original equipment manufacturing) business.

The Metaphor of the "Wild Geese Flying Pattern"

- The metaphor of the "wild-geese-flying pattern" of East Asian economic development over time (Kaname Akamatsu (1962)) suggests that industrialisation will spread from economy to economy as the initially fast-growing economies, beginning with Japan, run out of surplus labour and face labour shortages, rising real wage rates, and quota restrictions on their exports.
- Thus, East Asian industrialisation spread from Japan to first Hong Kong, and then Taiwan, and then South Korea, and then Southeast Asia (Thailand, Malaysia, Indonesia), and then to Guangdong, Shanghai, Jiangsu and Zhejiang in Mainland China. During this industrial migration, the large trading firms such as Mitsubishi, Mitsui, Marubeni and Sumitomo of Japan and Li and Fung of Hong Kong played an important role as financiers, intermediaries and managers of logistics and supply chains.

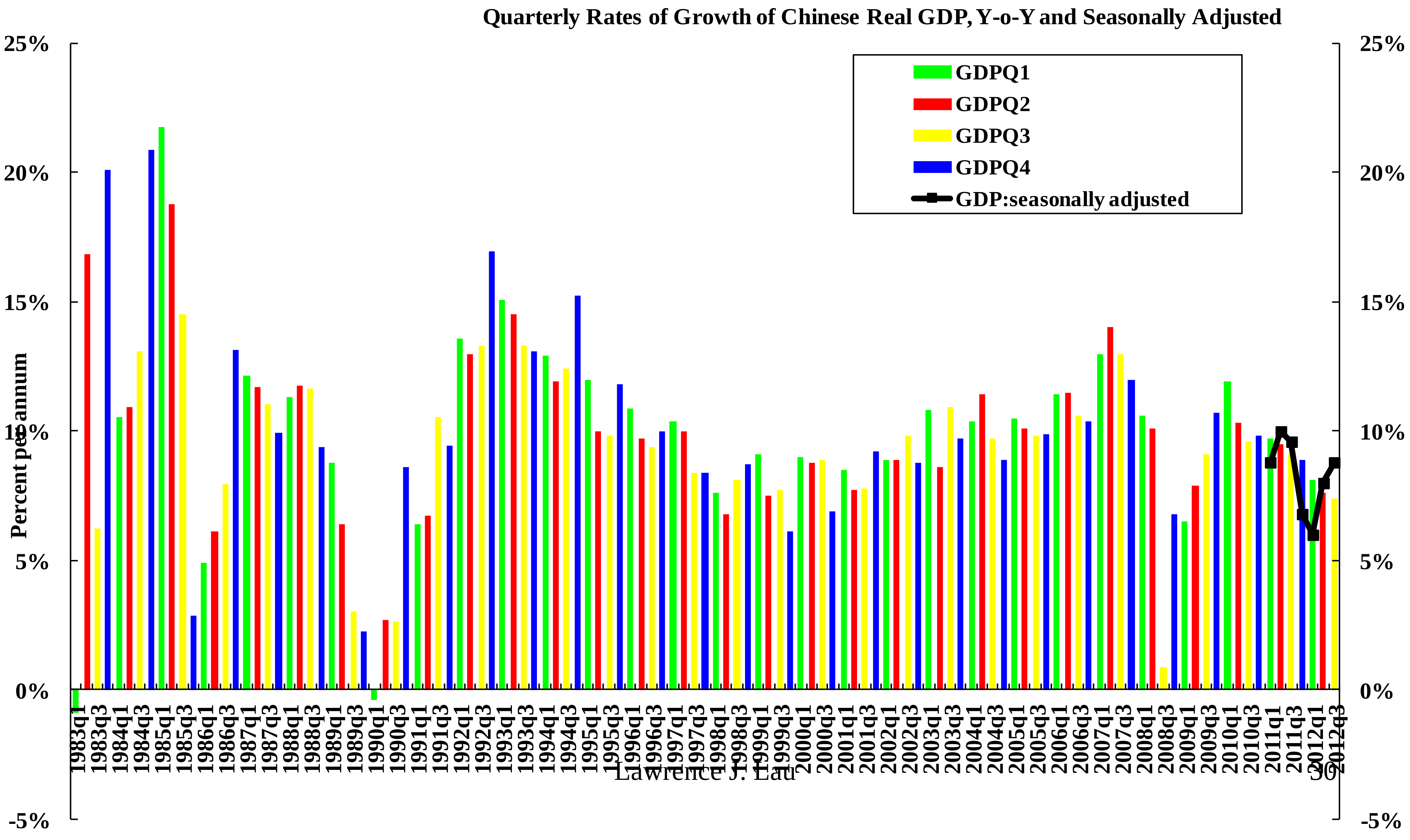
The Metaphor of the "Wild Geese Flying Pattern"

- This metaphor applies not only to East Asia but also to China itself. Within China, industrialisation first started in the coastal provinces, regions and municipalities. It has begun to migrate and spread to other provinces, regions and municipalities in the interior—to Chongqing, Henan, Hunan, Jiangxi and Shaanxi. As the coastal provinces, regions and municipalities slow down in their economic growth, the central and western provinces, regions and municipalities will take their turn as the fastest growing areas in China. China as a whole will be able to maintain its high rate of growth for many years to come.

The Macroeconomic Outlook

- The Chinese economy grew 9.2% in 2009, 10.4% in 2010 and 9.2 % in 2011 even as the European and U.S. economies remained in recession.
- In 2012Q1, the rate of growth of real GDP was 8.1%, Y-o-Y, and 6% per annum, seasonally adjusted, according to revised data of the National Bureau of Statistics.
- In 2012Q2, the rate of growth of real GDP was 7.6%, Y-o-Y, and 8% per annum, seasonally adjusted, up from the 6% of Q1.
- In 2012Q3, the rate of growth of real GDP was 7.4%, Y-o-Y, and 8.8% per annum, seasonally adjusted, according to revised data of the National Bureau of Statistics.
- In all likelihood, the rate of growth for the whole year should be above 7.5%, even with a lackluster Q4.

Quarterly Rates of Growth of Chinese Real GDP, Y-o-Y and Seasonally Adjusted



The Macroeconomic Outlook

- The official target growth rate for the year, announced by Premier WEN Jiabao at the National People's Congress, is 7.5%. The official target average growth rate for the Twelfth Five-Year Plan (2011-2015) period is a relatively modest 7%.

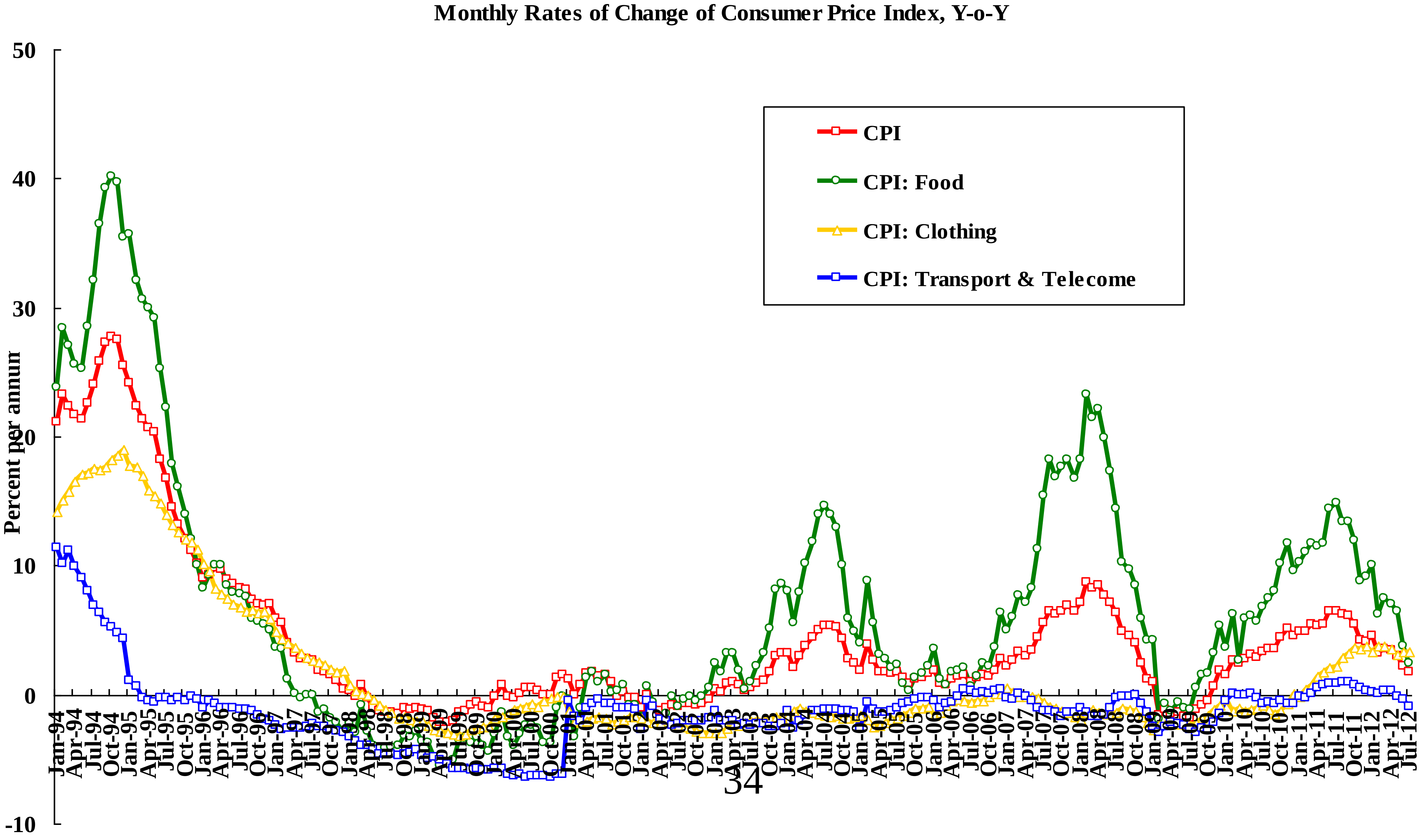
The Macroeconomic Outlook

- The recent slowdown in the Chinese economy is due, in part, to the continued weakness in exports to the United States and Europe, and in part, to the change in the inventory behaviour of importers in the United States and Europe (attempting to minimise the holding of inventory), and in part to the political uncertainty surrounding the once-in-a-decade political transition in China itself. Just as U.S. firms hold off on important investment decisions until after the U.S. presidential election in November, Chinese enterprises, state-owned or otherwise, have the incentive to wait until the new administration is in place in March 2013.

The Macroeconomic Outlook

- For 2011 as a whole, the rate of inflation exceeded the objective of the Chinese Government of 4%, at 5.4%, an increase from the 3.3% of 2010.
- For the first ten months of 2012, the rates of inflation as measured by the CPI year-over-year were 4.5%, 3.2%, 3.6%, 3.4%, 3%, 2.2%, 1.8%, 2.0%, 1.9% and 1.7%. The overall trend is unmistakeably downward. Seasonally adjusted, most of the rates were negative.
- The government target for 2012 is to keep the rate of inflation to below 4%, which appears not only feasible but likely to be surpassed, that is, closer to 3% at this time.

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



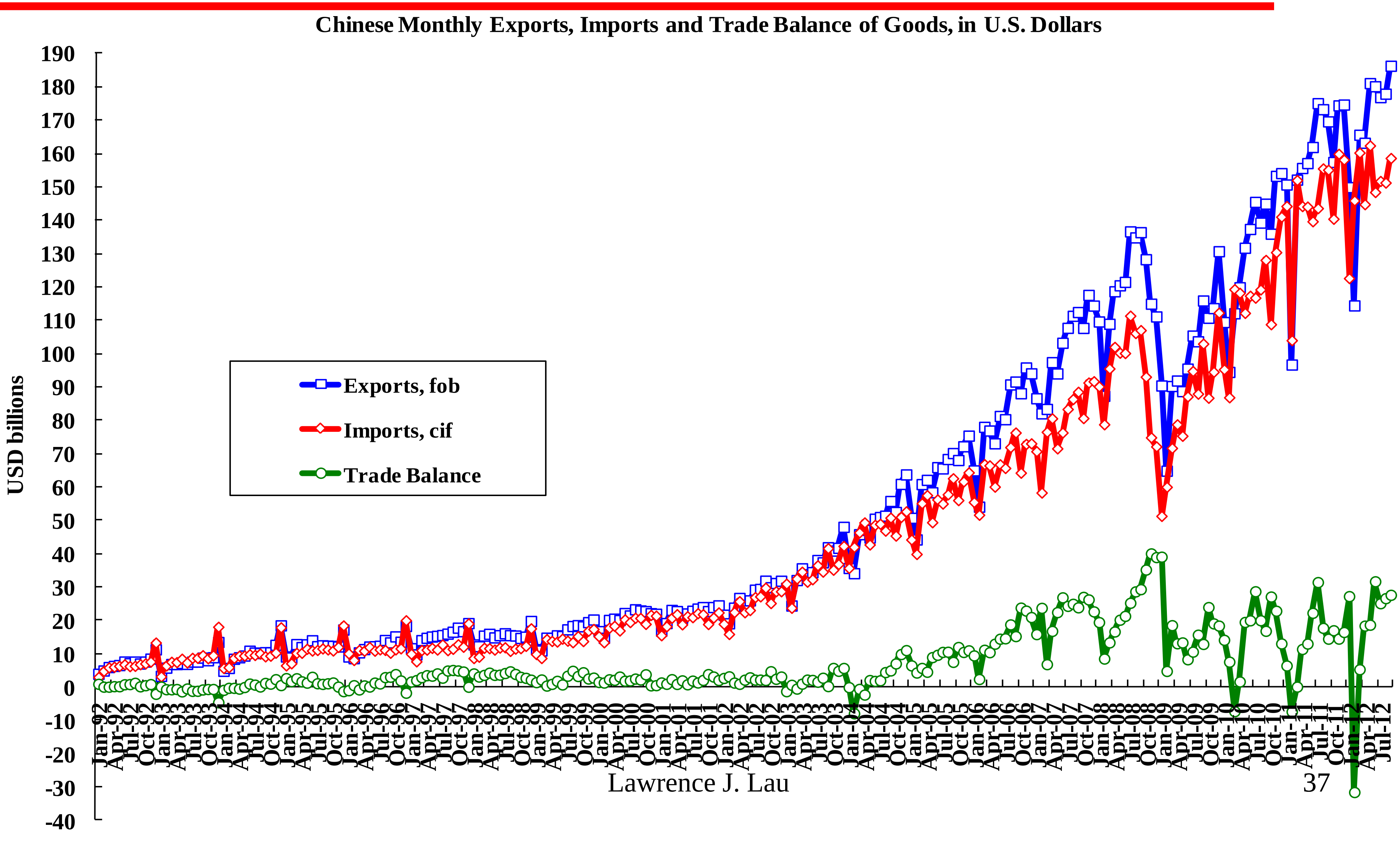
The Relative Unimportance of International Trade

- 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.

The Relative Unimportance of International Trade

- 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 around 2 percent at the end of 2011. It is expected to continue to decline, perhaps to around zero, some time between now and 2015.
- Thus, Chinese international trade 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 more than 40%.

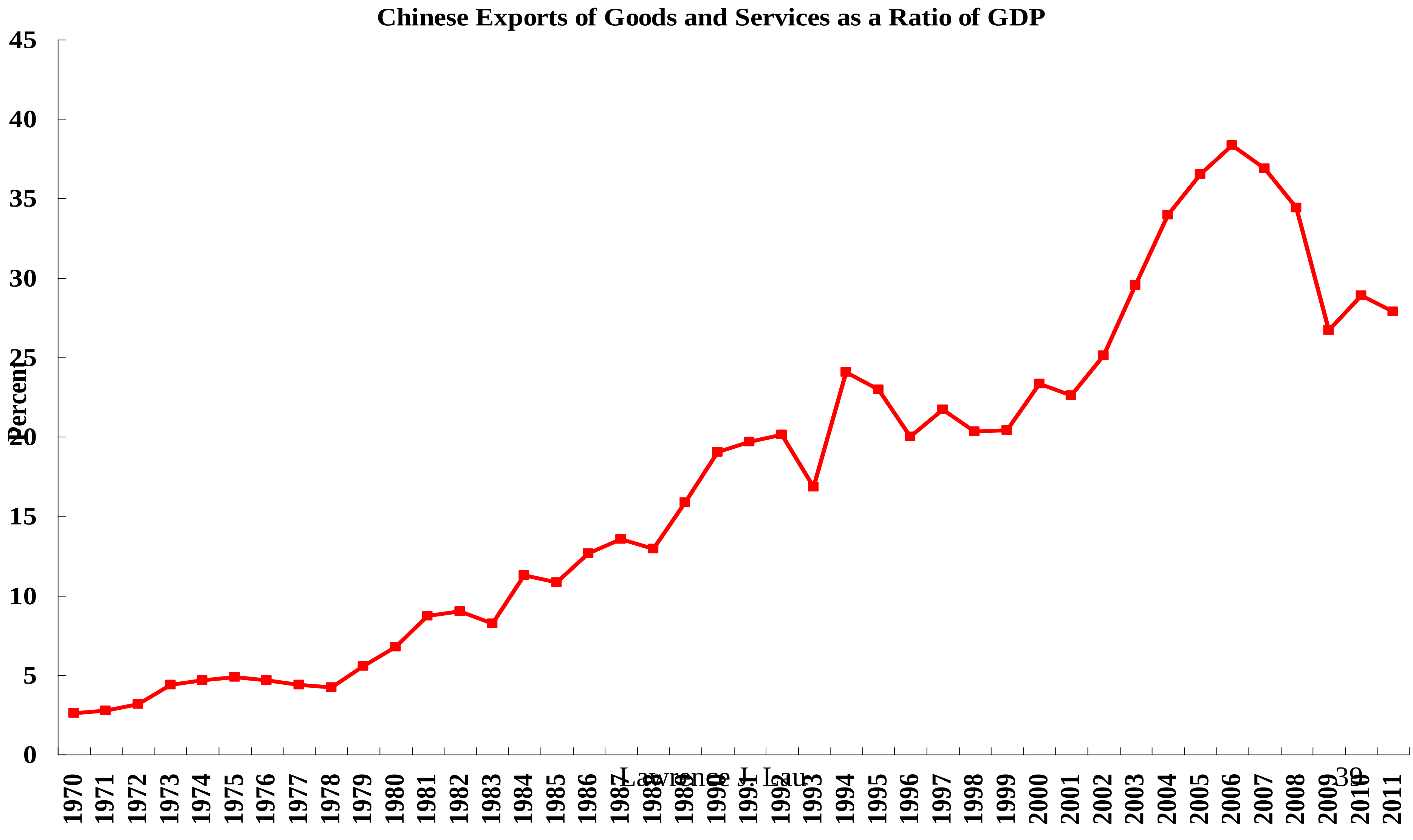
Chinese Monthly Exports, Imports and Trade Balance, US$



The Relative Unimportance of International Trade

- 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, where it stands today.
- While this ratio appears large, it is not when compared to Hong Kong, Singapore, South Korea and Taiwan, where exports are often several hundred percent of the respective GDPs.
- 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



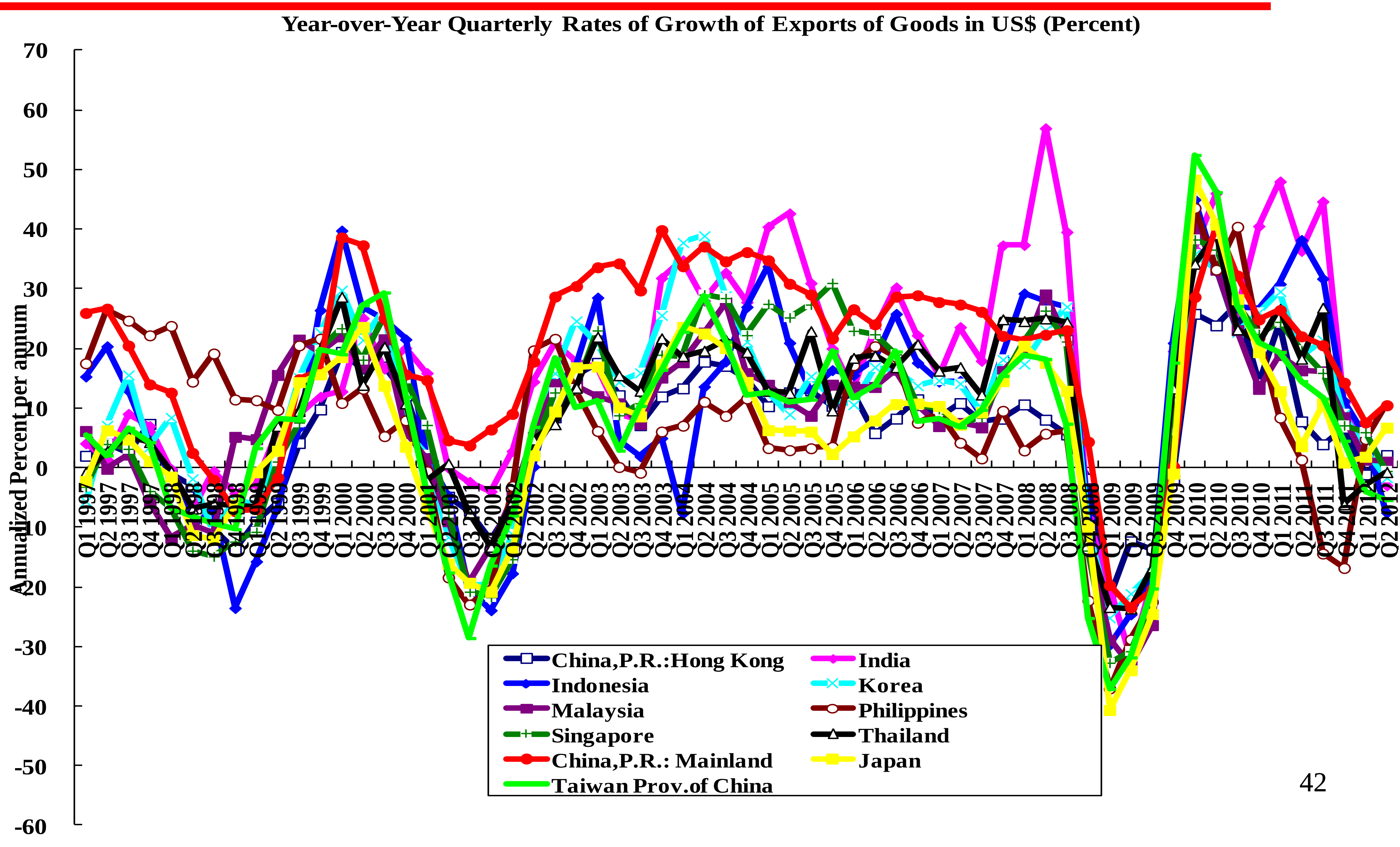
The Relative Unimportance of International Trade

- The domestic value-added content of Chinese exports is no more than 30 percent, that is: for every dollar of Chinese goods exported, less than 30 cents, on average, consist of domestic value-added. The rest consists of imported raw materials, intermediate goods, components, parts, semi-finished goods, etc. The domestic value-added percentage is even less for the so-called "Processing and Assembly" exports, which account for more than half of total Chinese exports.
- For example, Apple's i-Pad, which is assembled in China, with an export value of approximately US$500, generates a value-added in China of only US$15.

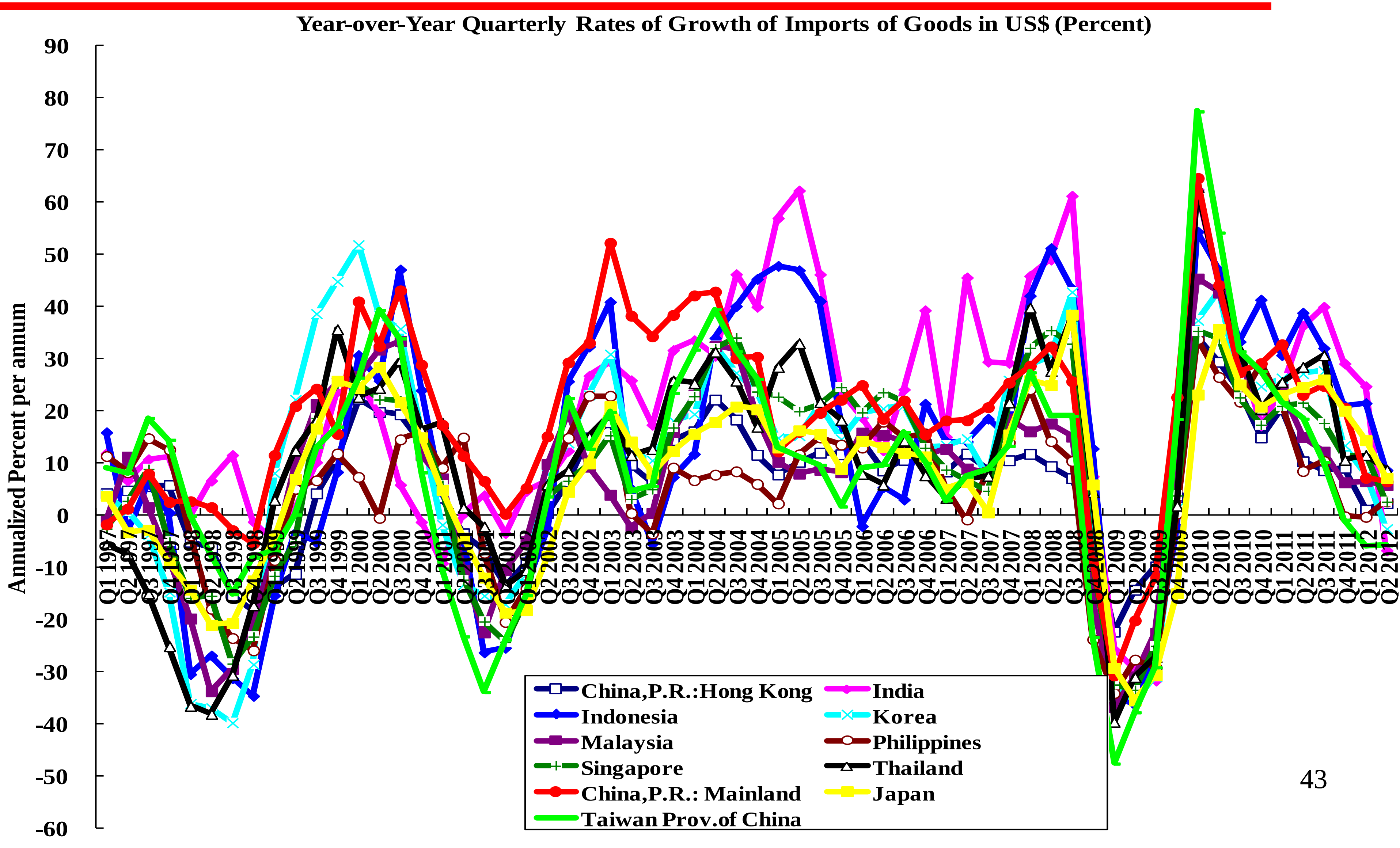
The Relative Unimportance of International Trade

- An important implication of the relatively low export dependence of Chinese GDP is that the rate of growth of Chinese real GDP is relatively stable, unlike the other East Asian economies, 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 exports, imports and real GDP of East Asian economies).
- In addition, China is a large, continental economy like the United States, that is relatively self-sufficient and is therefore relatively insulated from disturbances in the rest of the World.

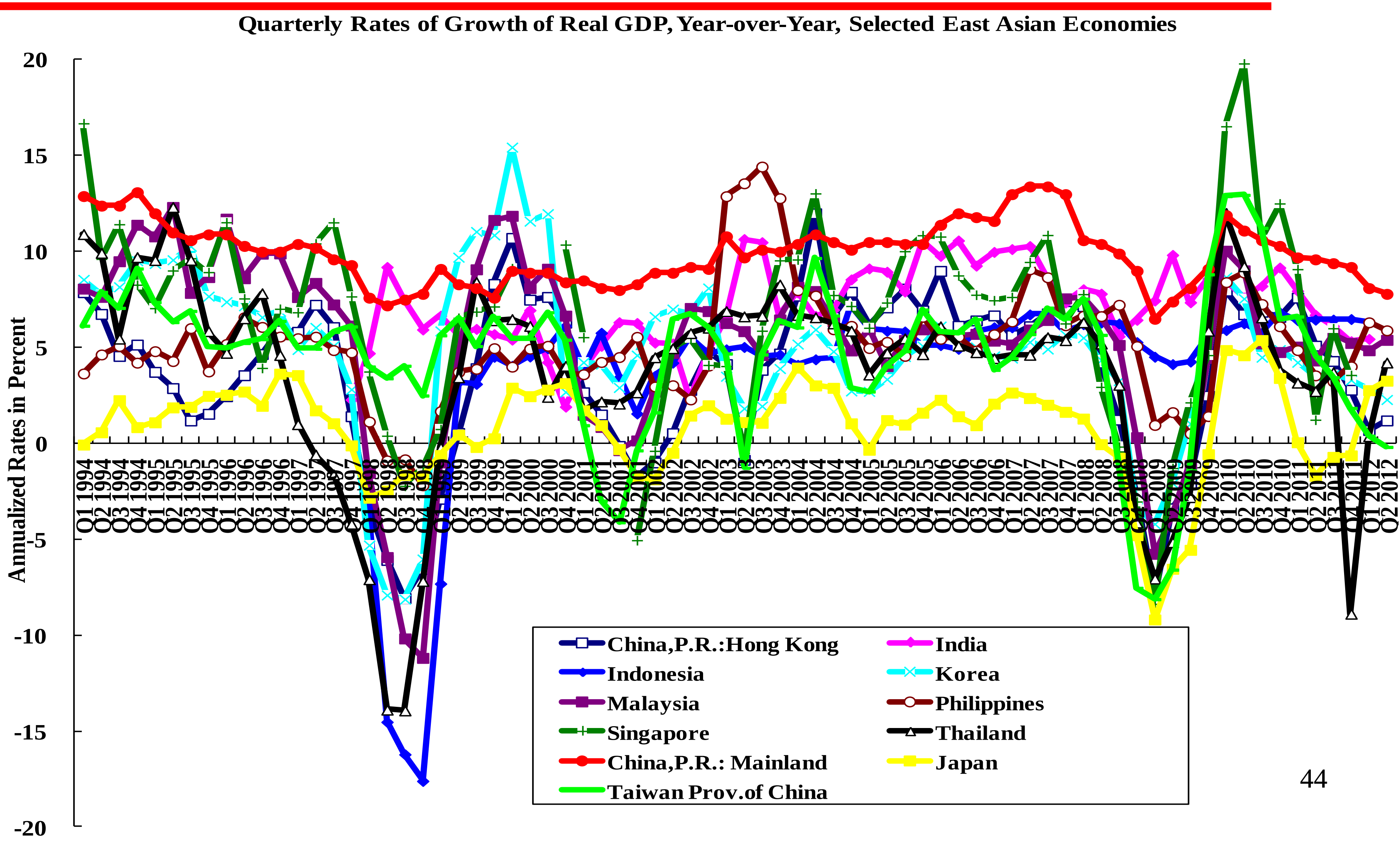
Quarterly Rates of Growth of Exports of Goods: Selected East Asian Economies



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



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



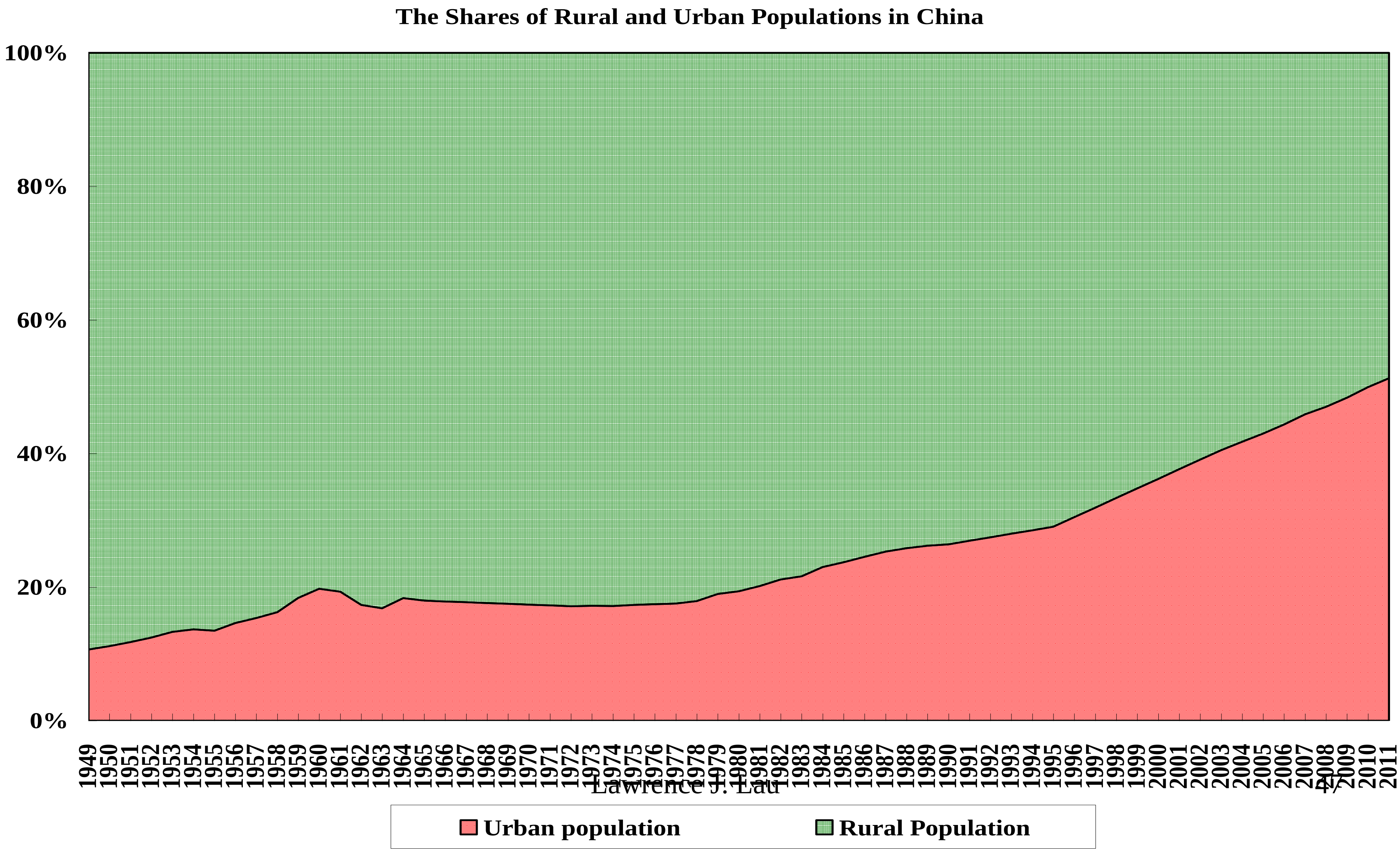
Sources of Sustainable Growth of Aggregate Demand

- Chinese household consumption is sometimes viewed as a potential sustainable source of growth of Chinese domestic aggregate demand.
- Chinese household consumption 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 begun to slow since 2011 but still exceeded the rates of growth of real GDP or real household income for the corresponding period.

Sources of Sustainable Growth of Aggregate Demand

- The possible areas that have the potential of generating sustainable increases in aggregate demand, in addition to household consumption and public infrastructural investment (e.g., high speed railroads, mass-transit systems, power plants, etc.), include:
- (1) Acceleration of urbanisation;
- (2) Residential housing;
- (3) Education and health care and the application of high technology in these sectors; and
- (4) Conservation of energy, environmental protection and preservation, and promotion of the green economy.

The Shares of Rural and Urban Population in China, 1949-Present



The Challenges and Opportunities of the Next Decade: The Seven Challenges

- The imbalances in the Chinese population
- The rationalisation of the tax system
- Reducing the degree of inequality of the income distribution
- Towards full convertibility of the Renminbi
- The regulation of market power
- The regulation of the financial sector
- The control of corruption

The Imbalances in the Chinese Population

- Chinese population is projected to reach a peak in 2035 and then begin to decline.
- The working-age population is projected to begin to decline in a few years.
- The ageing of the population is occurring rapidly.
- The dependency ratio is going to rise sharply and is not sustainable in the long run—a couple will have to support two set of parents, four sets of grandparents and one or possibly two children (if the couple themselves are single children).
- The differential and some would say discriminatory treatment of the urban and rural populations needs to be gradually reduced and ultimately eliminated.

Reform of the Policies Related to Population

- The "one child" policy, which has been beneficial for the Chinese economy, needs to be re-evaluated.
- The retirement ages, currently 55 for women and 60 for men, need to be re-thought as it is on the one hand a waste of human capital and on the other hand too costly to support the retirees in view of their lengthening life expectancies.

Reform of the Policies Related to Population

- The financing method for pensions must be changed from defined benefits to defined contributions.
- They should be fully vested in real individual accounts rather than virtual accounts.
- The separate social security funds of the different provinces, municipalities and autonomous regions probably need to be unified and merged into a common fund to facilitate geographical mobility of the labour force and to enable the sharing of risks across provinces, municipalities and autonomous regions.

Reform of the Policies Related to Population

- The discriminatory treatment between urban and rural residents should be gradually eliminated. The provision of public goods such as education, health care, clean air and water by the central or provincial government in the rural areas can be a most effective instrument in reducing the gaps in the living standard and degree of satisfaction between the urban and rural areas.
- Consideration should be given to confer permanent residency rights to the migrant labourers in the urban areas if they have had stable employment and have been a resident for a fixed period, say seven years.
- China should try to avoid growing too old before growing rich!

The Rationalisation of the Tax System

- The provincial and local governments do not have adequate recurrent revenue to fulfill their responsibilities whereas the central government has enjoyed large and rising budget surpluses.
- The local governments have reverted to the sale of land in various forms to raise revenue—this gives them an incentive to push for high and rising land prices and thus creating and fueling a property price bubble.

The Rationalisation of the Tax System

- As the central government has had persistent budget surpluses and the provincial governments do not have enough financial resources, perhaps the sharing formula between the central, provincial and local governments used for the Value-Added Tax (VAT), established in 1994, can be modified. This should provide the provincial and local governments with more recurrent revenue and reduce their dependence on land sales and bank loans.

The Rationalisation of the Tax System

- Dedicated sources of recurrent revenue, such as a property tax, should be created for the provincial and local governments, so as to wean them from the reliance on land sales and hence on high and rising land prices and to enable them to finance the public services they must provide to the local population—education, health care, police and fire safety, clean environment, etc.
- The property tax has already been introduced in Chongqing and Shanghai on a pilot basis and is likely to be extended to the whole country soon.

Introduction of New Taxes

- A resource tax should be introduced on natural resources such as coal, gas, oil, and other minerals. The tax will encourage conservation of such scarce resources. The tax should be shared between the central, provincial and local governments.
- Wherever possible, the resource tax revenue for the provincial and local governments should be placed in a trust fund for the benefit of the present and future generations of the local residents. Only a fixed percentage of the trust fund can be paid out each year for the use of the local government so as to provide another reliable and sustainable source of recurrent revenue. The payout should be at the long-term real rate of return of the trust fund so that the principal of the trust fund is intact in real terms and can provide an annual stream of inflation-protected revenue indefinitely into the future.

Introduction of New Taxes

- Proceeds from land sales should be treated in the same way as the revenue generated from the selling of a piece of land by the government is also one-off.
- Natural resources, including government-owned land, will be exhausted one day. By putting the tax revenue and land sale revenue in a trust fund, a stream of payouts can be provided indefinitely for the benefit of not just the current generation of residents but also all future generations.
- In some countries, such as the United Kingdom and Australia, the mineral rights under the ground do not belong to the owner of the land above the ground but can be sold separately. This is a possible model for China to follow.

Extending the Value-Added Tax Reform to the Service Sector

- The Value-Added Tax should also be extended to cover the service sector as well replacing the business or turnover tax which is levied on the gross revenue of the service sector enterprises rather than the value-added. Again, there are on-going pilot projects in Shanghai and elsewhere.
- This will make more equitable the relative tax burdens between enterprises in the secondary sector (consisting of manufacturing, mining and construction) and in the tertiary sector (service sector) and help accelerate the development of the tertiary sector, which provides much more employment per unit value-added (GDP) than the secondary sector.

Extending the Value-Added Tax Reform to the Service Sector

- The growth of the service sector also complements the urbanisation drive—urbanisation greatly expands the scope of the service sector, which also consists mostly of small and medium enterprises.
- Moreover, the service sector consumes much less energy per unit of GDP, and is thus consistent with Chinese efforts to conserve energy, reduce emission, and prevent climate change.

Reform of the Individual Income Tax: A Comprehensive Income Tax

- The Chinese individual income tax system can use two reforms. First, it should become a comprehensive income tax, integrating the income of an individual from all sources: salaries and wages and other personal earnings, cash dividends, interest, proprietor’s income, capital gains, etc. instead of leaving the different categories of personal income separate with each taxed at its own separate rates.
- After the integration of all the categories of personal income, including possible losses, one single progressive income tax scale should be applied to the total income. This has the virtue of being more fair and equitable. To the extent the income tax rates are progressive, individuals with higher total incomes will pay taxes at higher rates.

Reform of the Individual Income Tax

- Under the current non-integrated individual income tax system, salaries and wages are taxed with a top marginal rate of 45%, which is reached very rapidly, whereas dividend income is only taxed at a flat rate of 20%. Thus, a salaried worker may have to pay taxes at a marginal rate of 45%, whereas his boss, who owns the business, only has to pay a marginal rate of 20% if he takes all his compensation in the form of cash dividends. This is hardly equitable.
- For another example, a retired widow receiving 3,000 Yuan a year from the interest on her savings account at a bank has to pay a flat rate of 5% (it used to be 20%) on this only income of hers, whereas a wage earner earning 6,000 Yuan a year does not have to pay any individual income tax as the earner will fall within the zero tax bracket. The point is that under a comprehensive income tax, the retired widow's annual total income of 3,000 Yuan should also be below the threshold for the payment of any individual income tax.

Reform of the Individual Income Tax: Rationalising the Tax Schedule

- Second, the existing tax schedule which applies to salaries and wages only is too "progressive" in the sense that marginal tax rate rises too fast with respect to the level of salaries and wages earned. The marginal tax rate reaches the top rate of 45% very quickly. The degree of "progressivity" will be even higher if all items of personal income are integrated into a single comprehensive individual income tax base. Thus, with integration, the tax brackets should be widened significantly and the maximum marginal rate should be lowered significantly.

Reform of the Individual Income Tax

- With these widened tax brackets and lowered maximum marginal rates, the total individual income taxes collected will actually be higher than before. This is due to three effects:
- First, the additional taxes resulting from the integration of all the personal income tax items into a single tax base.
- Second, the lowered tax rates, coupled with increased enforcement, reduce the incentive to evade taxes.
- Third, the lowered marginal tax rates will encourage greater efforts on the part of the individuals.

Reform of the Individual Income Tax

- I believe there should just be three wide brackets with rates of 5%, 15% and 25% respectively, and that 25% should be the maximum marginal rate.
- The maximum marginal rate should be set at the same rate as the highest corporate income tax rate so that there is no incentive for the taxpayer to game the tax system by shifting income between the individual and the corporation that the individual owns. It should be the same for the owner of a corporation to pay himself a salary or not take the salary but leave it in the corporation as retained earnings after the corporate income tax.

Reform of the Individual Income Tax

- One critical reform for the success of the integration of all items of personal income taxes into a comprehensive personal income tax is the requirement that all payments to an individual, be it salaries and wages, cash dividends, interest, proceeds of sales of property including stocks and bonds, be reported to the central tax authorities annually under a single tax identification number unique to that individual. This will make it possible to enforce tax evasion by comparing the tax returns filed by the individual and the payers of salaries and wages, cash dividends, interest, proceeds of sales of property, etc.
- The individual income tax should be collected centrally by the central government, subject to sharing agreements with the provincial and local governments.

Reform of the Corporate Income Tax

- One important reform would be to make cash dividends paid by a corporation deductible from the corporate income in the same way as interest payments. This way the payment of interest and the payment of cash dividends will be identical to a corporation from the point of view of tax. On the margin, this will make corporations more willing to pay cash dividends, which should be encouraged for many other reasons. The corporation will be indifferent between raising funds in terms of equity or debt, eliminating one factor favouring debt over equity. Thus, this will help reduce overall leverage in the economy. Finally, through the payment of more cash dividends, the corporation will also be able to raise more equity capital, its share price will be higher, other things being equal, and moreover its share price will have a natural support floor.

Reform of the Corporate Income Tax

- Another important reform would be to reform the headquarters system of corporate taxation and move to a value-added basis of corporate taxation, in accordance with the geographical distribution of the income-generating activities. For example, a corporation may be headquartered in Haikou, Hainan, but conduct business activities all over the country. The VAT tax, which is shared between the central and provincial governments, should be shared not just between the central government and Hainan, but between the central government and all the provinces, municipalities and autonomous regions, in accordance with the geographical distribution of the value-added generating activities. This is not only more equitable, but will also discourage jurisdiction "shopping" on the part of enterprises and "competitive" offering of preferential treatment on the part of the provincial governments.

Reducing the Degree of Inequality of the Income Distribution

- The integration of the individual income categories and the introduction of a comprehensive individual income tax will make the distribution of the tax burden more equitable and reduce the degree of income disparity. The comprehensive individual income tax can also be used as a direct instrument of redistribution if at some future date a "negative" income tax is introduced; but for a proper implementation the "negative" income tax should await the full extension of the individual income tax to cover the rural as well as the urban areas.

Reducing the Degree of Inequality of the Income Distribution

- The provision of public goods such as education, health care, clean environment, is also an effective means for redistribution, and for narrowing the degree of inequality of the effective income distribution, say between the urban and the rural areas.
- Disparity in the income distribution is most unacceptable when the high income is not due to merit or efficiency but to corruption and other means of ill-begotten gains. That is why the prevention, prosecution and punishment of corruption and tax evasion is so important.

Towards Full Convertibility of the Renminbi

- 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 RMB as an Invoicing and Settlement Currency for Cross-Border Transactions

- Chinese exporters and importers in selected provinces, municipalities and autonomous regions have been permitted to settle their cross-border trade transactions in Renminbi in Hong Kong since 2009 on a voluntary basis, by mutual agreement between the exporter and the importer in each case. The practice has been extended to the whole of Mainland China by the end of 2011.
- More recently, the use of own local currencies of the trading partner countries for settlement of international trade transactions, for example, among China, Japan and South Korea, instead of in a major international reserve currency such as the U.S. Dollar or the Euro, has also become an option.

Towards Full Convertibility of the Renminbi

- Even though the Renminbi is not yet capital accounts convertible, it is de facto long-term capital accounts convertible. The capital flows for both inbound and outbound direct investment are readily approved (once the projects themselves are approved). So are applications for "Qualified Foreign (or Domestic) Institutional Investors," who are long-term portfolio investors into (or out of) China.
- It also seems likely that an international board will be set up soon on the Shanghai Stock Exchange for the shares of firms outside of Mainland China to be listed. Exchange-Traded-Funds (ETFs) for both Mainland and non-Mainland shares are also being contemplated on the Hong Kong and Shanghai Stock Exchanges.

Towards Full Convertibility of the Renminbi

- The problem with short-term cross-currency capital inflows is that they cannot be usefully deployed in the destination country. When they are used to finance long-term investment in the destination country, they invariably lead to trouble because of the maturity mismatch which is further exacerbated by the currency mismatch.
- However, as short-term capital flows in and out of the destination country, it can cause the exchange rate of the destination country to become excessively volatile, inhibiting the flows of cross-border trade and long-term direct and portfolio investment.

Towards Full Convertibility of the Renminbi

- A Tobin tax, originally suggested by the late Prof. James Tobin, Nobel Laureate in Economic Sciences, may be defined as a tax of say 0.5% (or 1%) on all spot conversions of a foreign currency into Renminbi or vice versa that are not related to current-account transactions.
- Thus, foreign currency transactions related to the exports or imports of goods and services will be exempted from such a Tobin tax. In practice, even capital account transactions below a certain threshold level, say 2 million Yuan (approximately US$320,000 at current exchange rate), should probably also be exempted. (However, repeated conversions by the same individual or institution to take advantage of the exemption should be pooled together and taxed.)
- The Tobin tax is intended to impose a penalty on short-term purely financial round-trip excursions from a foreign currency into the Renminbi or vice versa.

Towards Full Convertibility of the Renminbi

- The Tobin tax is a rather effective way of "taxing," and hence discouraging, short-term cross-currency capital flows. If every time a foreign currency is converted into Renminbi or vice versa, a tax of say 0.5% is levied, then a round-trip within a month would amount to an effective cost of 12% per annum, whereas for a direct investment with a long time horizon of say 5 years, the tax will amount to only 0.2% per annum, virtually nothing.

The Regulation of Market Power

- The large Chinese domestic market enables the realisation of significant economies of scale in production, distribution, and innovation. The returns to intangible capital—patents, copyrights, brand names, business methods and models—are enormous in a large market because the costs of their creation are relatively fixed but once created, the marginal cost of making use of them is almost zero. Hence the returns to investment in intangible capital are disproportionately larger the larger the market.
- The markets must be regulated to prevent the abuse of market power by dominant firms. Whether a firm competes fairly or abuses its market power has no direct relation to its form of ownership, in particular, it does not seem to depend on whether a firm is state-owned or privately owned. Both types of enterprises have the same incentives to exploit their market power if unchecked by regulators.

The Regulation of Market Power

- All enterprises would prefer to monopolise or cartelise their markets if possible, because once a monopoly or cartel is established, profits become both easy and long-lasting. Competition takes too much effort and may actually reduce profits.
- The information and communication technology revolution greatly enhances the degree of economies of scale by greatly reducing the costs of communication, supervision and control. It also enables the efficient division and sub-division of the different stages of production of a product amongst those producers that are the most efficient at each respective stage.

The Regulation of Market Power

- The natural monopolies such as power generation and telecommunication must also be regulated. Left alone, all monopolies will exploit their market power to increase their profits, often at the expense of the consumers.
- It is the government's responsibility, using its regulatory authority and the anti-trust laws, to prevent monopolisation or cartelisation and to regulate the natural monopolies. It must maintain the openness and competitiveness of the markets. Market failures are not uncommon in the absence of adequate regulation. Sometimes non-market coordination (planning) may also be required.
- China can prevent the Chinese markets from being monopolised or cartelised by maintaining the openness of the Chinese economy to the World in both trade and investment.

The Regulation of the Financial Sector

- The method of disbursement of loans by Chinese commercial banks should be brought up to the current international practice.
- According to international practice, bank loans are not disbursed directly to the borrower in a lumpsum. Instead, the loans will be disbursed in tranches in accordance with the specified purpose of the loan and with the verified degree of actual progress. Even then, the loans are not disbursed to the borrower per se but directly to the contractors and suppliers of the borrower.

The Regulation of the Financial Sector

- For example, if a loan is for the financing the construction of a new factory, a first tranche of the loan might be disbursed at the request of the borrower to the seller or lessor of the land, upon delivery of satisfactory title by the seller or lessor. The funds will be paid directly by the lending bank to the seller or lessor and will not pass through the hands of the borrower.
- A second tranche might be disbursed, when the foundation of the factory building is laid, directly to the contractor, again upon request from the borrower and receipt of a satisfactory inspection report on the foundation work.

The Regulation of the Financial Sector

- A third tranche might be disbursed when the factory building is completed, again, directly to the contractor upon the issuance of the occupancy permit by the relevant governmental authority.
- Finally, the last tranche might be disbursed directly to the supplier of the factory equipment, upon its satisfactory installation and test run, at the request of the borrower.
- If this practice is strictly followed, the loan proceeds will always go only for the intended purpose, and will never be diverted. This means the lender will always have real collateral (the completed factory with the installed equipment in the example) with an original cost that is at least as large as the loan itself. Its market value may be less, but at least there is something to show for the loan.

The Regulation of the Financial Sector

- More importantly, using this method of loan disbursement, it is not possible for the borrower to use the proceeds for other than the stated purpose. The borrower does not have access to the funds and cannot use them to speculate in either the stock market or the property market or in other markets.
- Moreover, the borrower cannot re-lend the funds, at a significant interest rate spread, say 4 percentage points or more, to other borrowers who do not have access to commercial bank loans. These re-lending loans can actually be quite risky because normally only very desperate borrowers with a high probability of default will pay such high rates of interest for credit.

The Regulation of the Financial Sector

- Thus, if the banking regulatory agency requires the commercial banks to strictly implement this simple and straightforward method of loan disbursement, the non-performing loan ratios of the commercial banks can be significantly reduced. Implementation of this disbursement method can also reduce or even eliminate the over-borrowing on the part of the large, mostly state-owned, enterprises for the purpose of re-lending. The actual loan demand of these enterprises will decline, leaving the commercial banks with more lending capacity to lend to the small and medium enterprises which did not have access to direct commercial bank loans in the past.

The Regulation of the Financial Sector

- However, it will not work for a single Chinese commercial bank to adopt this practice on its own. It will only lose all of its customers, who will migrate to other banks still disbursing loans in the same old way. It will take all the major Chinese commercial banks working together to make this a joint standard practice to have the desired effect. Thus, ultimately, it will require the issuance of direct and explicit regulations by the China Banking Regulatory Commission (CBRC) to make this method of loan disbursement a mandatory standard bank loan disbursement procedure.

The Regulation of the Financial Sector

- CBRC used to set the maximum deposit rate and minimum lending rate for all Chinese commercial banks. It has recently introduced some flexibility so that in principle a commercial banks can offer a slightly higher deposit rate and a slightly lower lending rate. This is viewed, in some quarters, as the beginning of the eventual liberalisation of the financial sector.
- However, the liberalisation of the financial sector is easier said than done. Even if the CBRC no longer sets the rates, the so-called "market rates" tend to be set by the largest banks through either explicit or implicit consensus, and which typically behave like a cartel. (The recent discovery of the rigging of the LIBOR rate by the world's largest commercial banks in London is a case in point.) In fact, the setting of deposit and lending rates by "consensus" of the banks is very common.

The Regulation of the Financial Sector

- There is also no doubt that the Chinese commercial banks welcome the setting of maximum deposit rate and minimum lending rate by the China Banking Regulatory Commission (CBRC) because of the large spread between the two rates of almost 300 basis points. The large spread may persist even if the CBRC no longer sets these rates because it is advantageous to the commercial banks.

The Regulation of the Financial Sector

- The buying and selling of financial derivative products should be strictly regulated, and approved products can only be traded on open public exchanges. The sale of instruments such as credit default swaps (CDSs) should be regulated in the same way as insurance products which they effectively are. The buyer of such an instrument should only be allowed to purchase an amount that is strictly less than the buyer's insurable interest, thus avoiding moral hazard.
- For example, a CDS on a bond is insurance against the default of the bond. Thus, only current bond holders should be allowed to purchase CDSs up to the current market value of the underlying bonds held.

The Regulation of the Financial Sector

- Publicly listed companies in China should be encouraged (and in the case of state-owned enterprises should be required by the government) to increase the payment of cash dividends to their shareholders from their profits. The increased payment of cash dividends by these companies generates many benefits for the economy.
- First of all, increased cash dividend payouts increase household income and thereby household consumption as well as household savings.

The Regulation of the Financial Sector

- They increase government revenue, both directly, as the government is a major shareholder in many publicly listed enterprises and will receive the increased cash dividends, and indirectly, through the increased individual income taxes collected on the cash dividends paid to the other shareholders. The increased government revenue can in turn be used to increase public consumption—e.g., the provision of public services such as education and health care, the preservation and restoration of the environment, etc.
- An increased cash dividend payout by a state-owned enterprise reduces its excess retained earnings so that it can no longer make investments at will—it will have to apply for loans and hence its investment projects will have to be justified to and evaluated by the lenders.

The Regulation of the Financial Sector

- Increased cash dividend payouts may make long-term holding of shares more attractive and may attract a different breed of investors. It will encourage investors to hold their shares longer and hence indirectly improve corporate governance as only long-term shareholders pay any attention to corporate governance.
- An increased cash dividend payout also provides a support level for the price of the shares of a publicly listed enterprise. The price of a share cannot fall too low as the dividend yield will become attractive relative to the rate of interest on bank deposits. Thus, the government does not need to worry as much about supporting the market.

The Regulation of the Financial Sector

- The ability to pay cash dividends on the part of an enterprise actually provides a real verification of the true profitability of an enterprise. An enterprise with only virtual or fictional or only accounting profits does not have the ability to pay out cash dividends whereas it can always declare stock dividends.
- The average cash dividend yield of common stock listed on Shanghai and Shenzhen stock exchanges has been rising slowly from 1.04% in 2009 to 1.14% in 2010 and 1.82% in 2011. Potentially the higher cash dividend yield can attract many more long-term investors into the Chinese stock market.

The Control of Corruption

- Salaries and wages of government civil servants must be raised to a level that their basic needs can be satisfied and that they can live with dignity. For example, the level of wage and salary can be set at the median of the market level of wage and salary of individuals with comparable qualification and experience in the non-state sector.
- Once salaries and wages have been adjusted, annual full financial disclosure should be required of civil servants above a certain grade and their spouses. Government civil servants will need to explain any unusual increase in their wealth (net worth). However, the confidentiality of these financial disclosures should be strictly maintained. They are only accessible by officials in charge of disciplinary or legal compliance matters.

The Control of Corruption

- Because of the prevalence of corruption at the present time, especially at the lower levels of government, it is necessary to have a system of one-off conditional amnesty for current or former government civil servants to give them an opportunity to come forward voluntarily to confess to their past corruption and/or tax evasion.
- A period of say a year or 18 months is allowed for such voluntary disclosure/confession to the relevant government authorities.

The Control of Corruption

- Then upon verification and the payment of a fine (which probably should not be less than half of the ill-begotten gains), there will be a full pardon for past offences. However, any future offences committed will be fully prosecuted and punished with fines and prison terms if found guilty.
- When the Independent Commission Against Corruption (ICAC) was introduced in Hong Kong in 1971, there was a wholesale amnesty for the Hong Kong police force except for a few top commanding officers. Without the amnesty, the police force may have revolted.

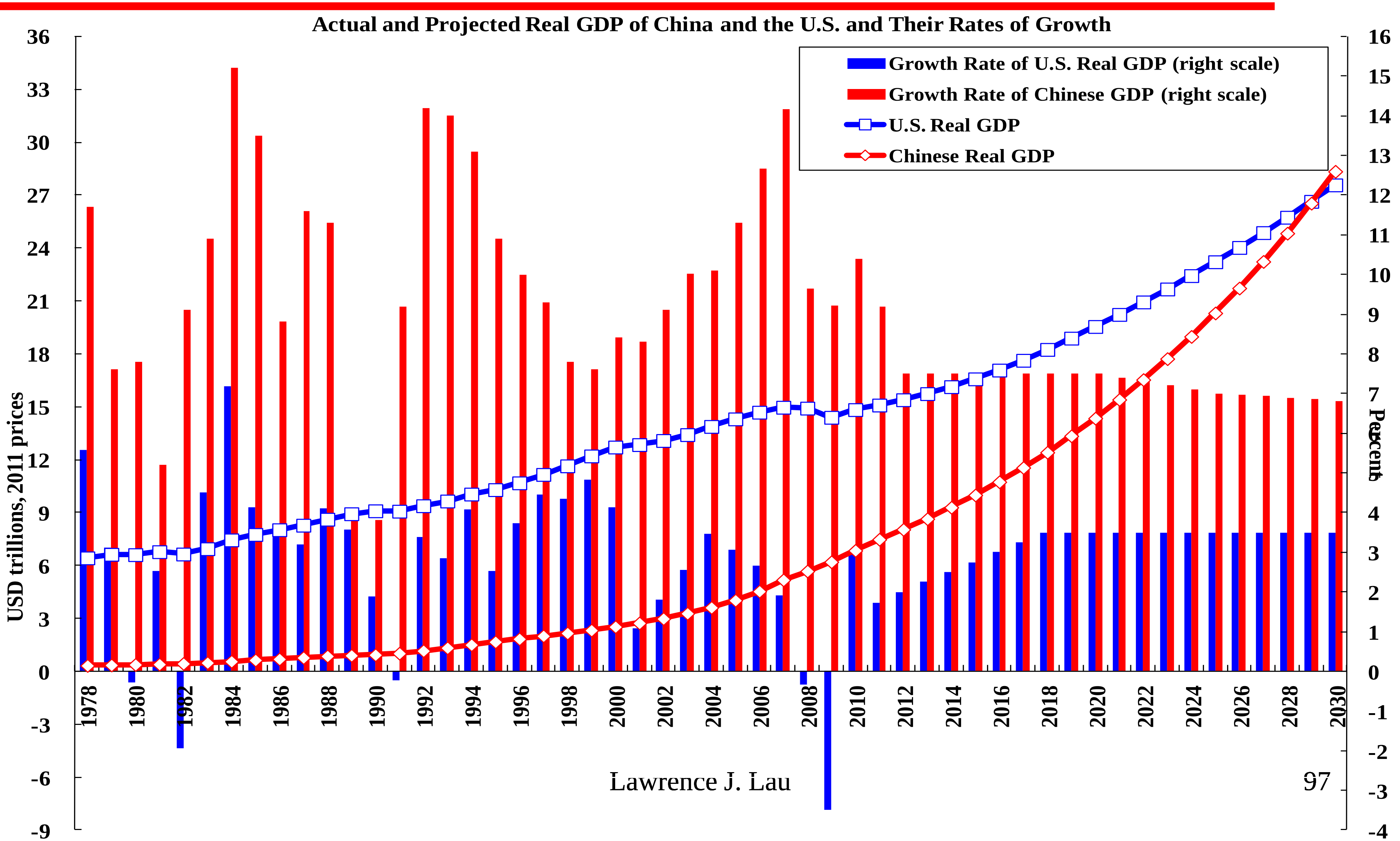
The Control of Corruption

- One reform that may facilitate the prosecution and punishment of corrupt government officials is the assumption of direct control of the entire judicial system (courts at different levels), including the appointment and promotion of judges, by the central government, as well as the direct financing of the entire judiciary system including the provincial and local levels by the central government.

Projections of the Future

- If current trends continue, with the U.S. economy recovering slowly but surely, East Asia as a whole will surpass the United States in terms of aggregate GDP with China contributing the highest proportion of the total by 2015.
- Chinese real GDP is projected to catch up to U.S. real GDP in approximately 18 years' time--around 2030, at which time both Chinese and U.S. real GDP will exceed US$28 trillion (in 2011 prices), almost four times the current Chinese GDP. (Bear in mind that in the meantime, the U.S. economy will also continue to grow, albeit at rates lower than those of the Chinese economy.)
- By this time, China and the U.S. will each account for approximately 15% of World GDP.

Actual and Projected Chinese and U.S. Real GDPs and Their Rates of Growth



Concluding Remarks

- On the basis of its economic fundamentals, China should be able to continue to grow around 7% per annum for the next couple of decades, more or less independently of what happens in the rest of the World.
- 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 several 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.
- China will develop into a largely internal-demand driven economy like the United States. International trade and international investment will not have a decisive impact on the Chinese economy.

Concluding Remarks

- The long-term sustainable sources of Chinese aggregate demand will all be internal: urbanisation (building new cities), public infrastructure, mass-transit systems, household and public consumption, residential housing, investment in education and health care, environmental protection and preservation, energy conservation and renewable energy, and the green economy.
- Chinese consumption will rise, as GDP per capita and wage rate rise and the social safety net is gradually perfected. But the national savings rate may remain high for a long time.

Concluding Remarks

- Exports as a share of Chinese GDP will probably continue to decline over time, as befitting a large, continental economy. Chinese international trade will become approximately balanced with the rest of the World.
- However, China may well become a net overseas direct as well as portfolio investor over the next decade.

Concluding Remarks

- None of the reforms proposed here earlier are easy. They required sustained determination. They will also require a long time for full implementation and for the beneficial effects to be felt. However, they must be started at some point.
- Reform without losers—In order to minimise opposition to these reform measures, it is best to grandfather existing vested interests—that is, new ways should be applied only to new people; old people should continue to be treated in the old way (新人新办法, 旧人旧办法).
- The visible hand (of the government) and the invisible hand (of the market) must work hand-in-hand to bring about an efficient, rational and equitable economy.

Concluding Remarks

- The World Bank has forecast a rate of growth of the Chinese economy of 7.7 percent for 2012 and 8.1 percent for 2013. The Asian Development Bank has also made identical forecasts for 2012 and 2013.
- For 2012, the short-term economic targets of the Chinese Government are to achieve a real rate of growth of 7.5 percent and to control the rate of inflation to below 4 percent. I am confident that both targets will be more than achieved.