

The Chinese Economy: Boom or Bust?

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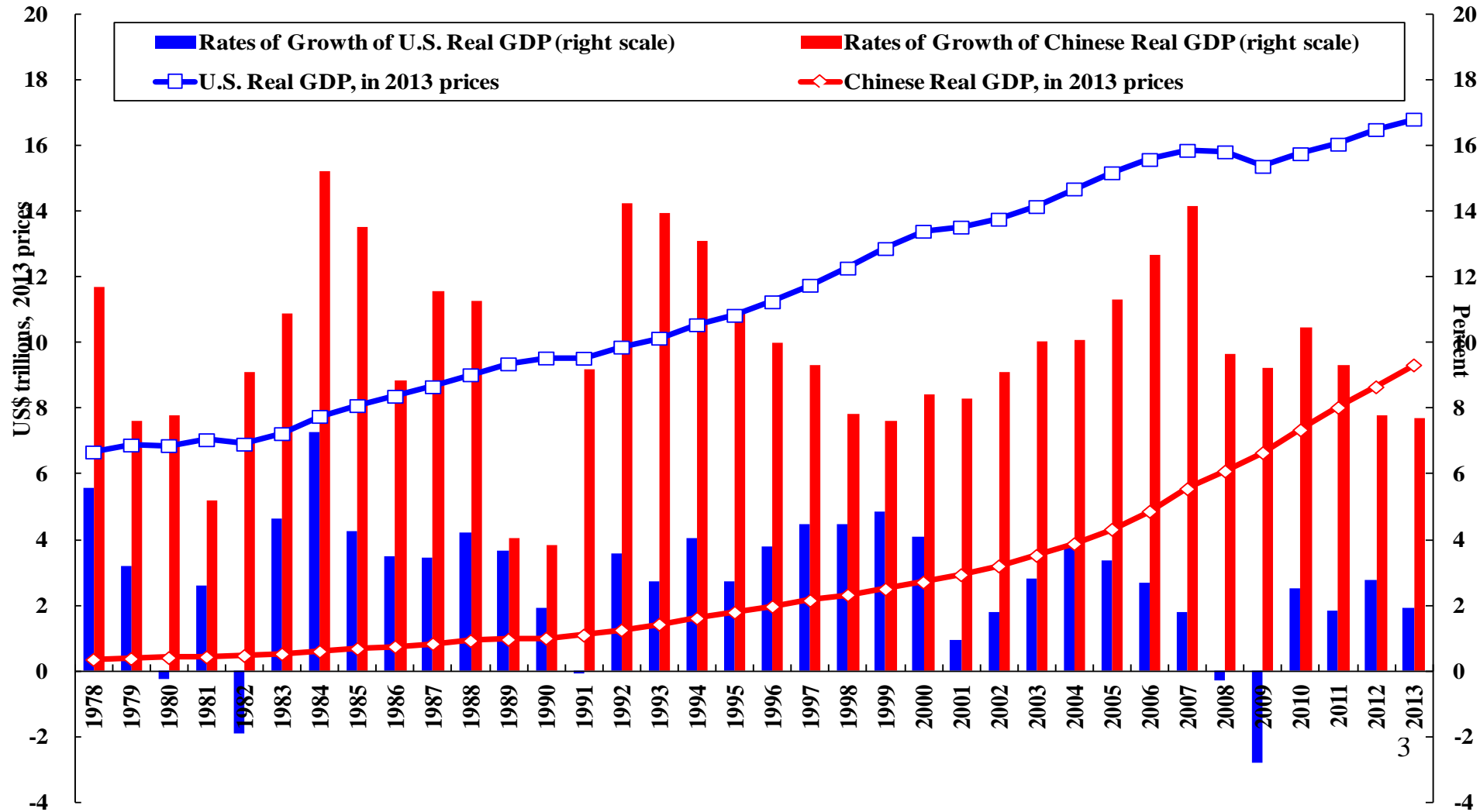
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The Alternate Strategies for Economic Transition

- ◆ In contrast, the transition from a closed centrally planned economy to an open market economy in China beginning in 1978 was smooth and highly successful, as the following two charts demonstrate. Both real GDP and real GDP per capita have grown rapidly and continuously beginning in 1978. There was not even a single year of decline in either aggregate or per capita real output as in the other formerly centrally planned economies.

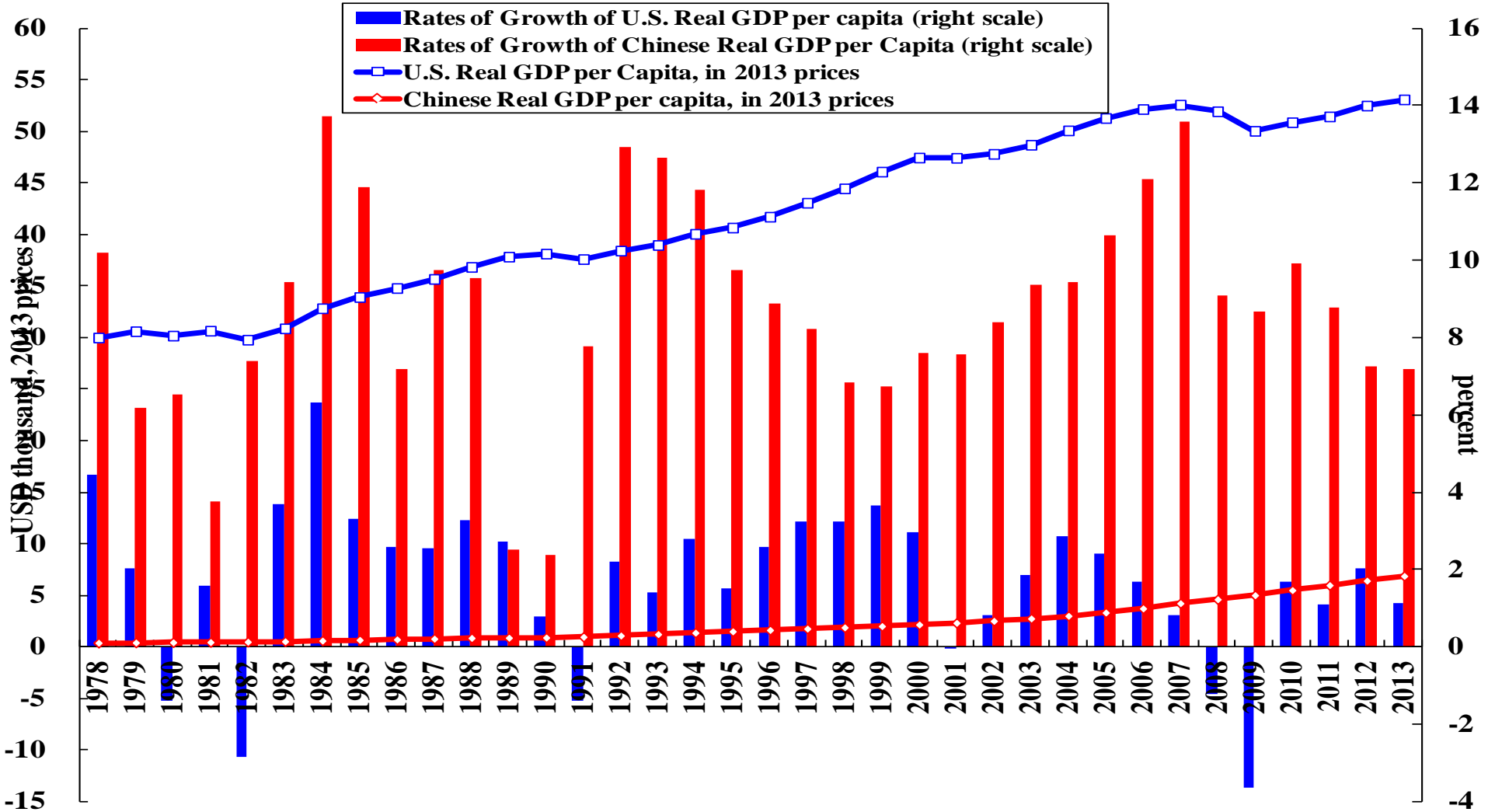
Real GDPs and Their Annual Rates of Growth: China & the U.S. (2013 US\$): 1978-present

The Real GDP and Its Annual Rates of Growth of China and the U.S.
(trillion 2013 US\$)



Real Chinese and U.S. GDP per Capita in US\$ Since 1978 (2013 Prices)

Real GDP per Capita and their Annual Rates of Growth of China and the U.S.,
(thousand, 2013 US\$)



The Alternate strategy for Economic Transition

- ◆ We have identified two factors that contributed to Chinese economic success: favourable economic fundamentals and the existence of surplus potential output. But these factors were also common to other transition economies such as those of the former Soviet Union and the Eastern European countries.
- ◆ What our previous charts have shown is that for a previously centrally planned economy, even though there might have been good economic fundamentals and prior economic inefficiency (and hence surplus potential output), introduction of producer autonomy and the free market and opening to the World may not be sufficient to assure a high rate of real economic growth and a successful economic transition. Only China was able to do so.

The Alternate strategy for Economic Transition

- ◆ Why was China able to succeed in its economic transition while the former Soviet Union and East European countries failed so miserably?
- ◆ It turns out that the choice of strategy for the economic transition matters.
- ◆ In the former Soviet Union and the Eastern European countries, the method used for the transition was the so-called “shock therapy” or “big bang”—that is, the immediate and full abolition of the mandatory central plan, relying only on the operations of the free markets (which were still new and primitive).
- ◆ In China, the principle of “reform without losers” was adopted—making sure that in every step of the economic reform, no one would be made worse off than before.

The Alternate strategy for Economic Transition: Reform without Losers

- ◆ Most economic reforms create both winners and losers. While it is true that in the aggregate, the gains from economic reform should outweigh the losses, it is often difficult, if not impossible, to redistribute the gains so that no one is worse off.
- ◆ There is, however, one principle that is unique to the Chinese experience, that is, the explicit avoidance of the creation of losers in the process of economic reform: “reform without losers.”
- ◆ Moreover, such a strategy can often not only result in everyone being better off than before, but also achieve full economic efficiency.

The Dual-Track Approach Adopted in the Chinese Economic Transition

- ◆ The Chinese Government did not adopt the “shock therapy” or the “big bang” approach to implement its economic reform.
- ◆ Instead of dismantling the mandatory central plan all at once, the Chinese Government adopted the “Dual-Track” approach. While introducing enterprise autonomy and free markets, it also continued to enforce the existing central plan. There were simultaneously two tracks in the economy: a “Plan Track” and a “Market Track”.
- ◆ The “Plan Track”--the pre-existing central plan remains and its rights and obligations continue to be enforced by the government.
- ◆ The “Market Track”--all markets are instantaneously open, with prices determined by supply and demand.

The Dual-Track Approach Adopted in the Chinese Economic Transition

- ◆ As long as their obligations under the plan have been fulfilled, producers (communes, townships, enterprises, households and individuals) are given the autonomy and incentive to plan their production on the margin and participate in the free markets, which are open to them, and are responsible for any profits and losses resulting from their market activities outside the central plan.
- ◆ Individuals are also completely free to plan their consumption and participate in the markets, given their allocated consumption goods and fulfillment of their labor obligations.

The Political Economy of the Dual-Track Approach

- ◆ No one is worse off under the “Dual-Track” approach, because everyone—a commune, a township, an enterprise, a household or an individual--has the option of staying with the pre-reform arrangements, with identical rights and obligations. Thus, there are “no losers” and everyone has the opportunity to “win”.
- ◆ All the “Vested Interests” were thus “Grandfathered.”
- ◆ Since no one loses and everyone can win, opposition to the economic reform was minimised, support for the reform was maximised, and social stability was preserved. Such a win-win strategy for economic reform has the best chance of success.

The Alternate strategy for Economic Transition: Reform without Losers

- ◆ As a result of the “Dual-Track” approach, the Chinese economic reform proceeded smoothly and did not result in economic chaos or contraction as in the former Soviet Union and Eastern European countries. The Chinese economy was able to continue to grow rapidly in the midst of its transition from a closed centrally planned economy to an open market economy.
- ◆ Ultimately, in the late 1990s, the centrally planned part of the Chinese economy, which had been contracting relative to the market part of the economy, became sufficiently insignificant so that the mandatory features of the central plan could be gradually phased out. The transition to an open market economy in goods and services (but not yet in factors) was thus completed.

Towards a Surplus Capital Economy

- ◆ After the completion of the transition to an open market economy, the Chinese economy grew rapidly on the basis of a high investment rate, surplus labour and economies of scale on the supply side and the expansion of export demand as a result of accession to the World Trade Organisation (WTO) and pent-up domestic demand of a rising middle class on the demand side.
- ◆ With an investment rate of over 40% of its GDP, China in the early 2000s has begun to become not only a surplus labour economy but also a surplus capital economy—there is too much capital invested, resulting in excess manufacturing capacities almost everywhere.

Towards a Surplus Capital Economy

- ◆ How did the surplus capital economy come about? It came about because of massively excess fixed investment in manufacturing. Fixed investment in manufacturing was undertaken by both state-owned and private enterprises without regard to its potential rate of return, often supported by local government officials.

Towards a Surplus Capital Economy

- ◆ Since the performance of Chinese local government officials are judged by key performance indicators which include the growth of the local GDP and employment, they have a strong incentive to do whatever is possible during their term of office to increase both GDP and employment. Beginning in the early 2000s, the local government officials began to make use of the land under their control to finance local development of manufacturing industries, such as steel, cement and glass as well as residential housing. In order to protect these local manufacturing industries, they imposed, illegally, effective bans on the use of competitive manufactured products of non-local origin.

Towards a Surplus Capital Economy

- ◆ Moreover, a local government official is usually promoted to a different locality at the end of his or her term and so is not too concerned with the longer-term viability of these fixed investment in manufacturing, leaving it for the successor to deal with.
- ◆ Private enterprises also participated in making fixed investment in manufacturing and in real estate development, either with the support of local government officials or with loans made possible by a loose credit culture.

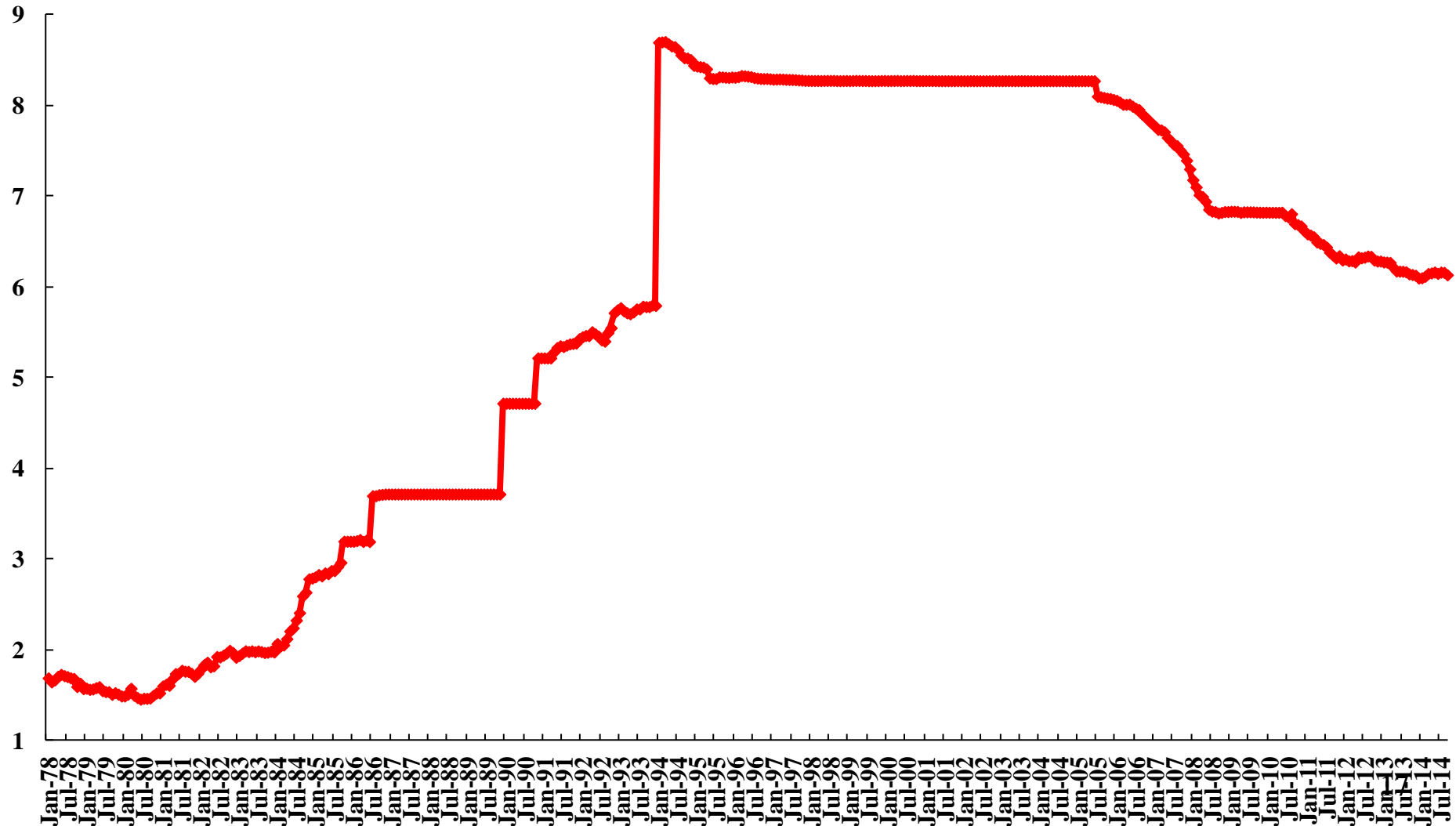
The Surplus Capital Economy:

The Chronically Excess Demand for Credit

- ◆ Even with a national saving rate in excess of 40%, there does not seem to be sufficient credit available in China. There seems to be a chronically excess demand for credit.
- ◆ One piece of evidence for the chronically excess demand for credit in China is the very high Renminbi rate of interest relative to the U.S.\$ rate of interest, even though the Renminbi has been appreciating in both nominal and real terms with respect to the U.S.\$ since 2005.
- ◆ This clearly contradicts the interest rate parity theory, which specifies that the rate of interest of the relatively appreciating currency should be lower than the rate of interest of the other currency by the percentage amount of the expected appreciation. (Granted that there exist capital control in China, but the control is at best leaky.) The Renminbi rate of interest has been much higher than the U.S.\$ rate of interest. See the following charts¹⁶.

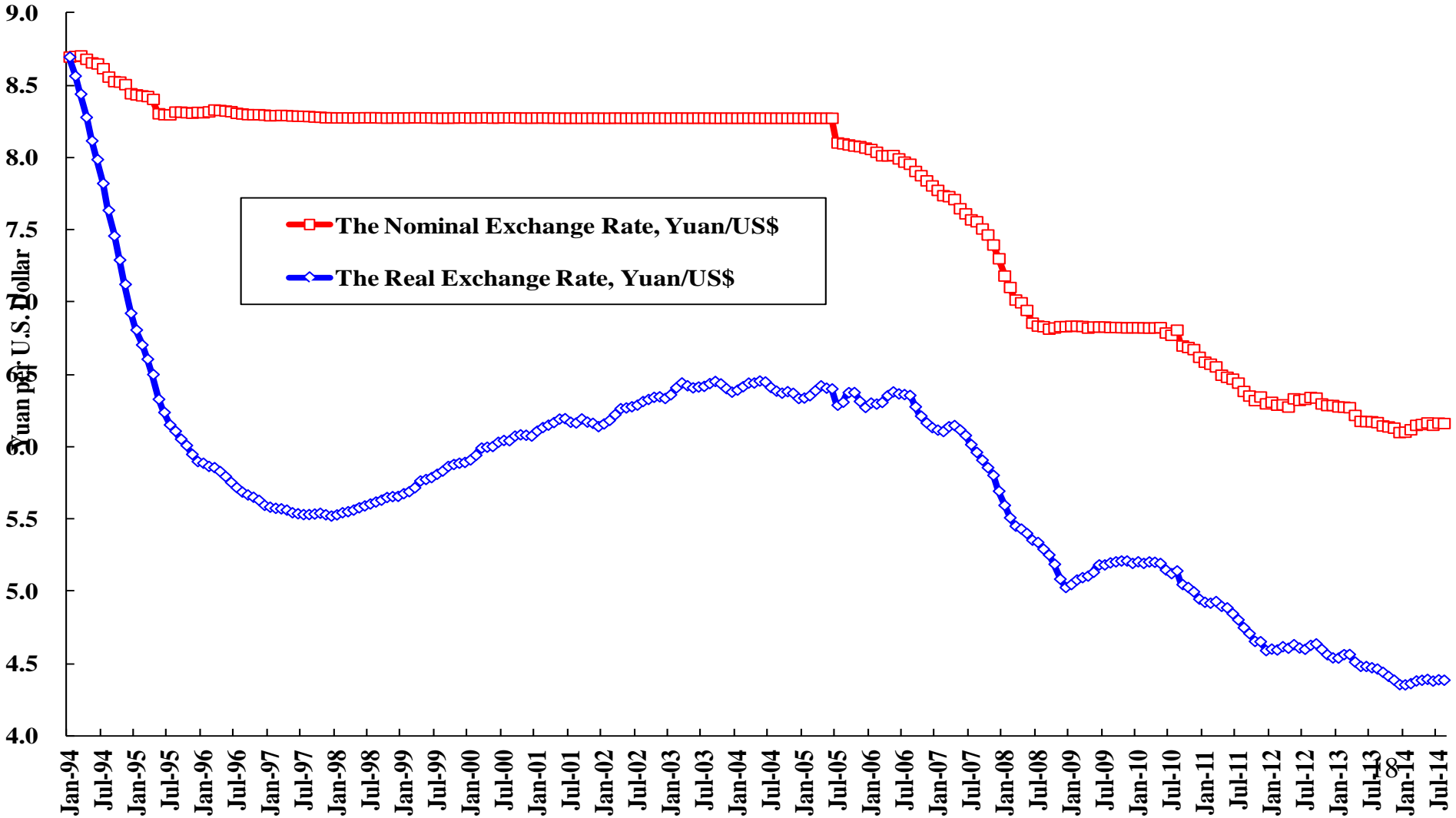
Nominal Exchange Rate of the Renminbi, Yuan/US\$, 1978-present

Nominal Exchange Rate of the Renminbi, Yuan/US\$, 1978-present



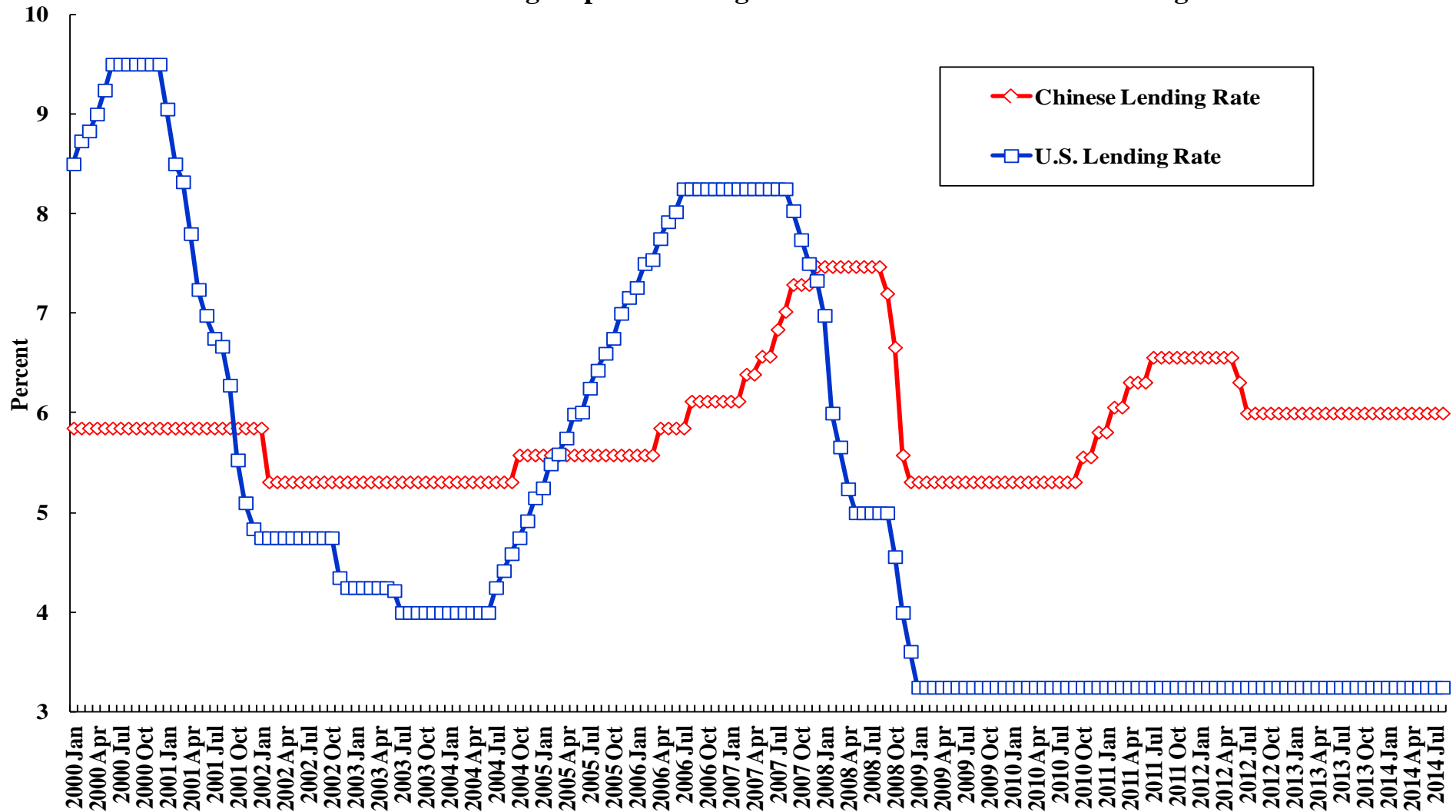
The Nominal and Real Yuan/US\$ Exchange Rates

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



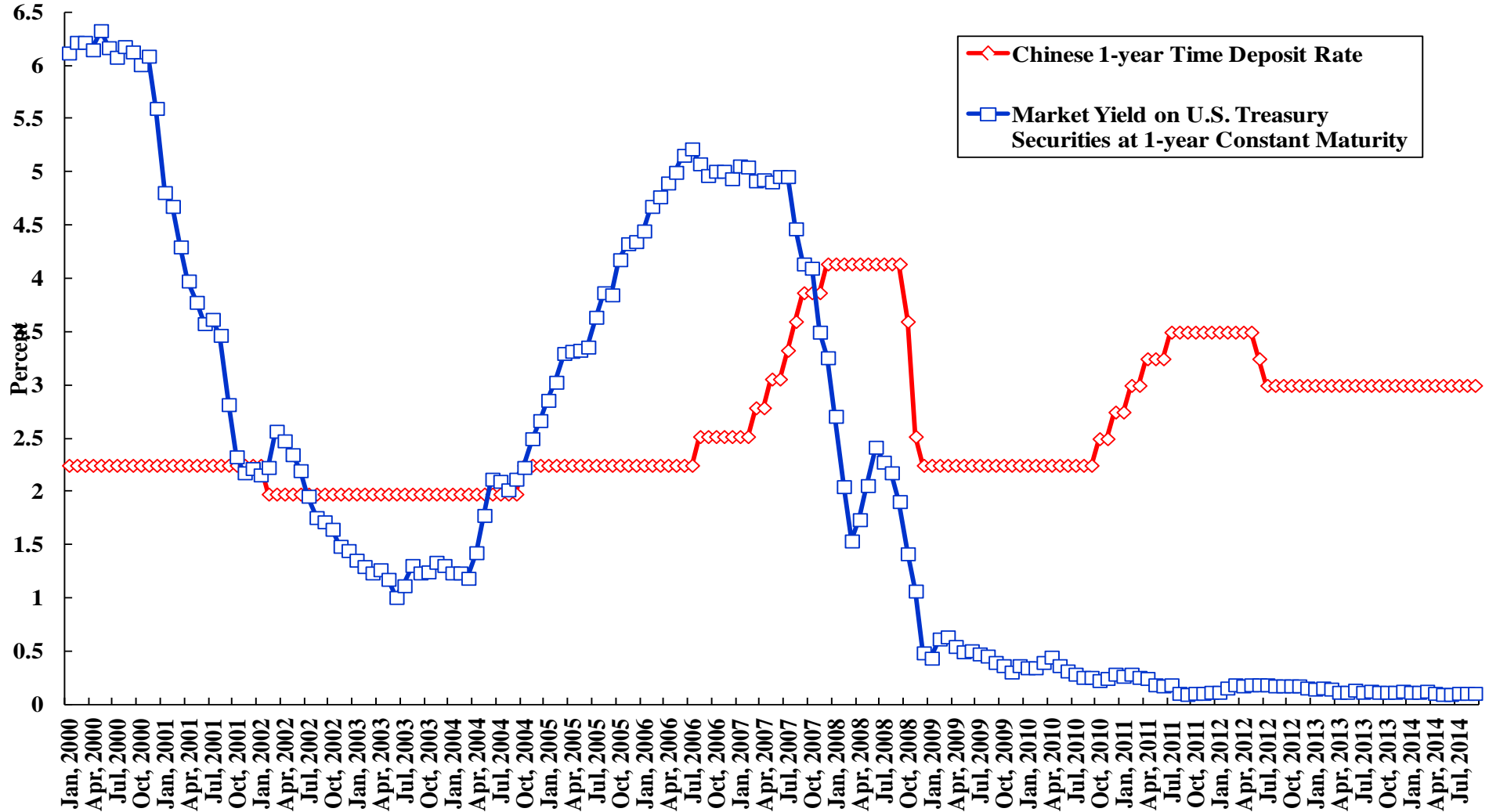
The Chronically Excess Demand for Credit: China-U.S. Lending Interest Rate Differential

Chinese 1-Year Working Capital Lending Rate and U.S. Short-Term Lending Rate



The Chronically Excess Demand for Credit: China-U.S. Deposit Interest Rate Differential

Chinese 1-Year Time Deposit Rate and Market Yield on U.S. Treasury Securities at 1-Year Constant Maturity



The Surplus Capital Economy: The Chronically Excess Demand for Credit

- ◆ The chronically excess demand for credit in China is caused by the fact that many borrowers or potential borrowers, including local governments, state-owned enterprises (SOEs) and private enterprises, do not plan to repay their loans if things do not work out as hoped. When borrowers do not plan to repay their loans when things turn sour, the level of the rate of interest does not matter very much. The result is a chronically excess demand for credit which results in a chronically high rate of interest in China.

The Surplus Capital Economy: Huge Excess Capacities in Manufacturing Sectors

- ◆ The fact that loans do not have to be repaid by the borrowers if things turn out badly leads to blind expansion of manufacturing capacities resulting in huge excesses in industries such as steel, cement, glass, aluminum, ship-building, solar panels, residential housing, etc.
- ◆ It also means that a high interest rate alone is not an effective deterrent to borrowing and to investment—this explains why the central bank has had to resort to credit rationing.
- ◆ The chronically excess demand for credit is also in part responsible for the growth of “shadow banking” in Mainland China. Shadow banking has resulted in higher “effective” borrowing rates for those enterprises and individuals who are able to obtain credit because of the shift to making “shadow loans” rather than regular bank loans on the part of banks.

The Surplus Capital Economy: Aggregate Demand-Constrained Output

- ◆ The massively excess fixed investment in manufacturing has resulted in huge excess capacities in China in industries such as steel, cement, glass, aluminum, ship-building, solar panels, residential housing, etc. at the present time.
- ◆ One important implication of the excess capacities in the Chinese manufacturing sector is that the Chinese real output or GDP is not supply-constrained but aggregate-demand-constrained—as long as there is aggregate demand, the supply will always be there to meet the demand.
- ◆ The Chinese GDP is therefore primarily determined by aggregate demand at the present time and the Government exercises a decisive influence on the level of aggregate demand.
- ◆ Thus, China should be able to continue to grow at an average annual rate of 7% for the next five to ten years, more or less independently of what happens in the rest of the World.

The On-Going Economic Challenges

- ◆ The Rapidly Aging Population
- ◆ The Anti-Corruption Campaign
- ◆ Shadow Banking
- ◆ Local Government Debt
- ◆ The Deficit in Human Capital
- ◆ The Innovation Gap
- ◆ The Excess Supply of Residential Real Estate

The On-Going Economic Challenges: Is a Hard Landing Likely?

- ◆ The principal challenge facing the Chinese economic policy makers is not so much the growth of real GDP but employment.
- ◆ In 2013, 13 million new jobs were created. In 2014, the target for new jobs is 10 million. This target is achievable as the service sector (46.1% by GDP and 38.5% by employment) is now larger and growing faster than the manufacturing sector (41.9% by GDP and 30.1% by employment). An expansion of service-sector GDP creates 30% more employment than an expansion of manufacturing-sector GDP and requires much less fixed investment.

The On-Going Economic Challenges:

The Rapidly Aging Population

- ◆ The rapid aging of the Chinese population is a challenge from the point of view of adequate provision of retirement benefits and elderly care.
- ◆ However, there will not be a “real” labour shortage despite the decline of the “working-age population”—the existing retirement ages of 55 for women and 60 for men are too low given the lengthened life expectancy of the Chinese population. One ready solution is to raise the retirement age to 65 (possibly on a voluntary and phase-in basis).
- ◆ The “one-child policy” is already in the process of being modified. The decision of the Third Plenum of the Eighteenth Central Committee allows a couple with one spouse being a single child to have two children. However, its effects on the size of the “working-age population” is not likely to be felt for at least a couple of decades.

The On-Going Economic Challenges: The Anti-Corruption Campaign

- ◆ The anti-corruption campaign has been quite successful so far, hitting both “tigers and flies” as promised. It has proved to be extremely popular with the public.
- ◆ The “Anti-Corruption” campaign has had some effect in discouraging initiatives on the part of some government officials. It is “safer” to do nothing in the midst of the campaign so as not to attract attention to oneself. Part of the recent slowdown in the rate of economic growth may therefore be attributed to the anti-corruption campaign (and the regulations against luxury consumption).

The On-Going Economic Challenges: The Anti-Corruption Campaign

- ◆ However, since ultimately the most important objective of the campaign is to deter future corruption and not to try to catch every government official who committed transgressions in the past, it is anticipated that at an appropriate time, after suitable safeguards against corruption have been put in place systematically, “victory” will be declared, with the new focus on deterring and punishing continuing or new acts of corruption.
- ◆ Reduction of official discretion is one way to reduce potential corruption but it may also lead to other potential problems.

The On-Going Economic Challenges: Shadow Banking

- ◆ “Shadow banking” has become more common in Mainland China in the last few years. Shadow banking arises in response to various restrictions on bank lending and other requirements such as the total quota on the value of loans outstanding and its rate of increase, capital requirements, leverage ratios, and reserve requirements.
- ◆ The fundamental idea of “shadow banking” is to move both “deposits” and “loans” off the bank’s balance sheet and hence reduce the size of its total assets and liabilities through various arrangements and devices, circumventing all kinds of requirements and restrictions.

The On-Going Economic Challenges: Shadow Banking

- ◆ Shadow banking also appears to generate advantages for everyone except possibly for the shareholders of the bank and for the regulator. The net result, however, is a significantly lower actual capital ratio and a significantly higher actual leverage, increasing the risks to the bank and to the financial sector as a whole.
- ◆ Moreover, the borrowers wind up paying much higher actual rates of interest.

The On-Going Economic Challenges: Shadow Banking

- ◆ The proportion of financing in China accounted for by conventional bank loans was over 90 percent in 2002 but has since fallen to below 50%. Shadow banking probably accounts for 17-20 trillion Yuan worth of “loans”, approximately 30% of GDP, still considerably lower than the comparable percentages in other major developed economies. But the commercial banks are involved in 60% of the shadow banking activities in China, much more than the commercial banks in other countries and regions.

The On-Going Economic Challenges: Shadow Banking

- ◆ This means that the implicit hidden liabilities of the commercial banks and hence their leverage ratios are much higher than are represented on their balance sheets, posing significant risks to the financial system because of the potential of over-leveraging. Moreover, there is unlikely to be sufficient provision against non-performing “shadow loans”.
- ◆ The Chinese regulators are aware of these problems and have been taking steps to control and restrict shadow banking.

The On-Going Economic Challenges:

Local Government Debt

- ◆ Total Chinese central government public debt may be estimated at 9.8 trillion Yuan as of mid-2013, with another 2.5 trillion Yuan of contingent liabilities of various kinds, including those of the China Railway Corporation.
- ◆ Total local government debt may be estimated at 10.9 trillion Yuan as of mid-2013, with another 7 trillion Yuan of contingent liabilities of various kinds. Total local government debt has increased significantly especially since 2008Q4.
- ◆ Private household debt may be estimated at 16 trillion Yuan and enterprise debt at around 70 trillion Yuan.
- ◆ To put all of these figures into perspective, the Chinese GDP in 2013 was 57 trillion Yuan. Total central and local government debt (including contingent liabilities) as a percentage of GDP may therefore be approximately estimated as 53%.

The On-Going Economic Challenges: Local Government Debt

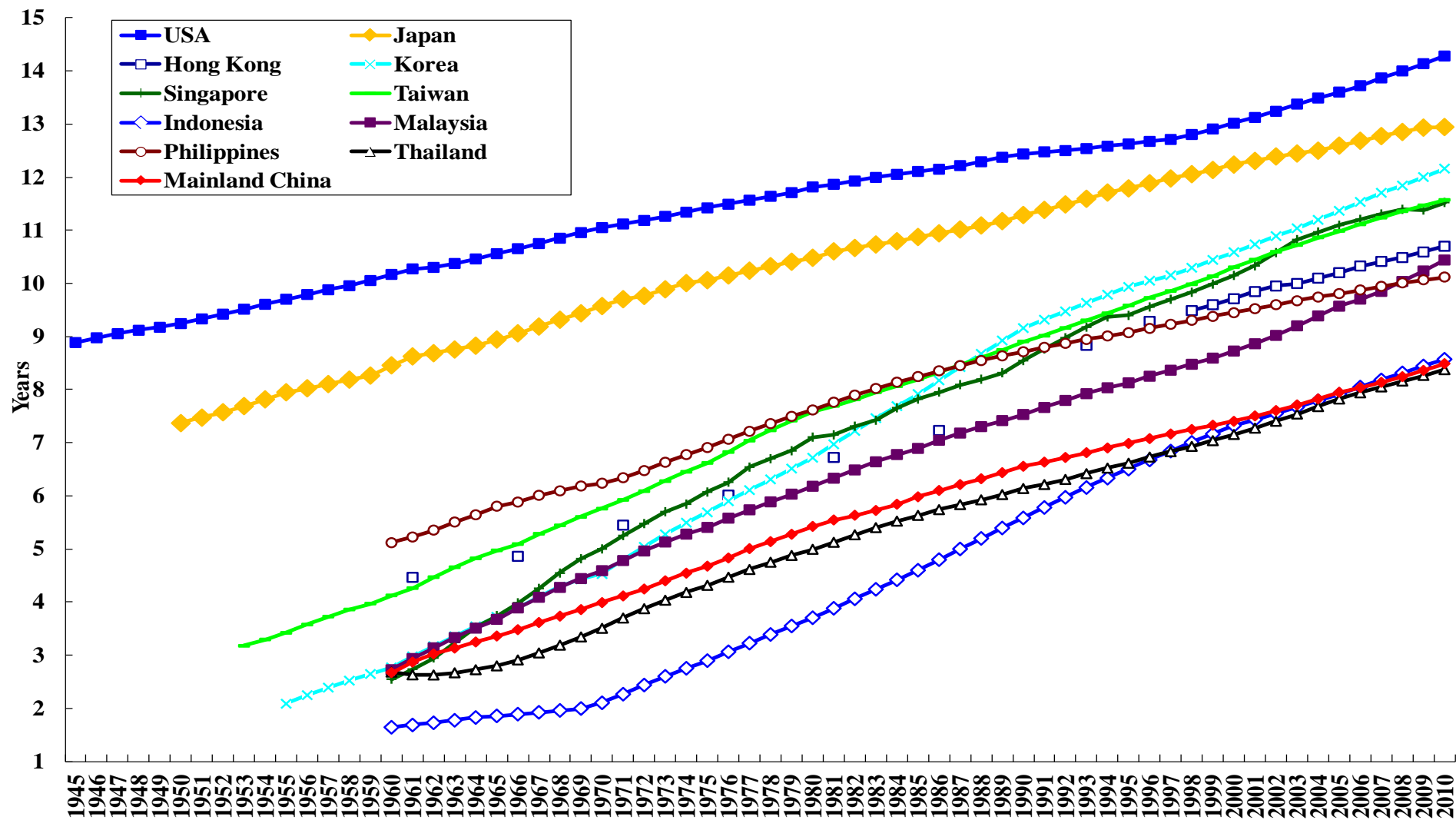
- ◆ However, it is unlikely that all of the local government debt would become non-performing. Even if half of the local government debt eventually becomes non-performing, in which case it is likely that part of the losses would be assumed by the central government, which will still have a relatively low public debt to GDP ratio of less than 40% compared to 150% for the U.S. and 250% for Japan.
- ◆ In addition, China has a high national saving rate in the mid forties. Its public debt is almost exclusively denominated in Renminbi and held mostly by Chinese nationals. The Government deficit is low and the rate of growth of government revenue has been higher than the rate of growth of GDP. All of this suggests that the public debt problem should be manageable.

The On-Going Economic Challenges: The Deficit in Human Capital

- ◆ One indicator of the level of human capital in an economy is the average number of years of schooling per person in the working-age population. In the following chart, the average number of years of schooling is compared across selected economies.
- ◆ By this measure, the United States and Japan are the clear global leaders. South Korea has been catching up fast. Most of the other East Asian economies also have quite rapidly increasing levels of human capital but it will take a while before they can catch up with the levels of human capital in the developed economies. China, Indonesia and Thailand have lagged behind in terms of investment in human capital.

Average Years of Schooling of Selected Economies (1945-present)

Average Years of Schooling of Selected Economies



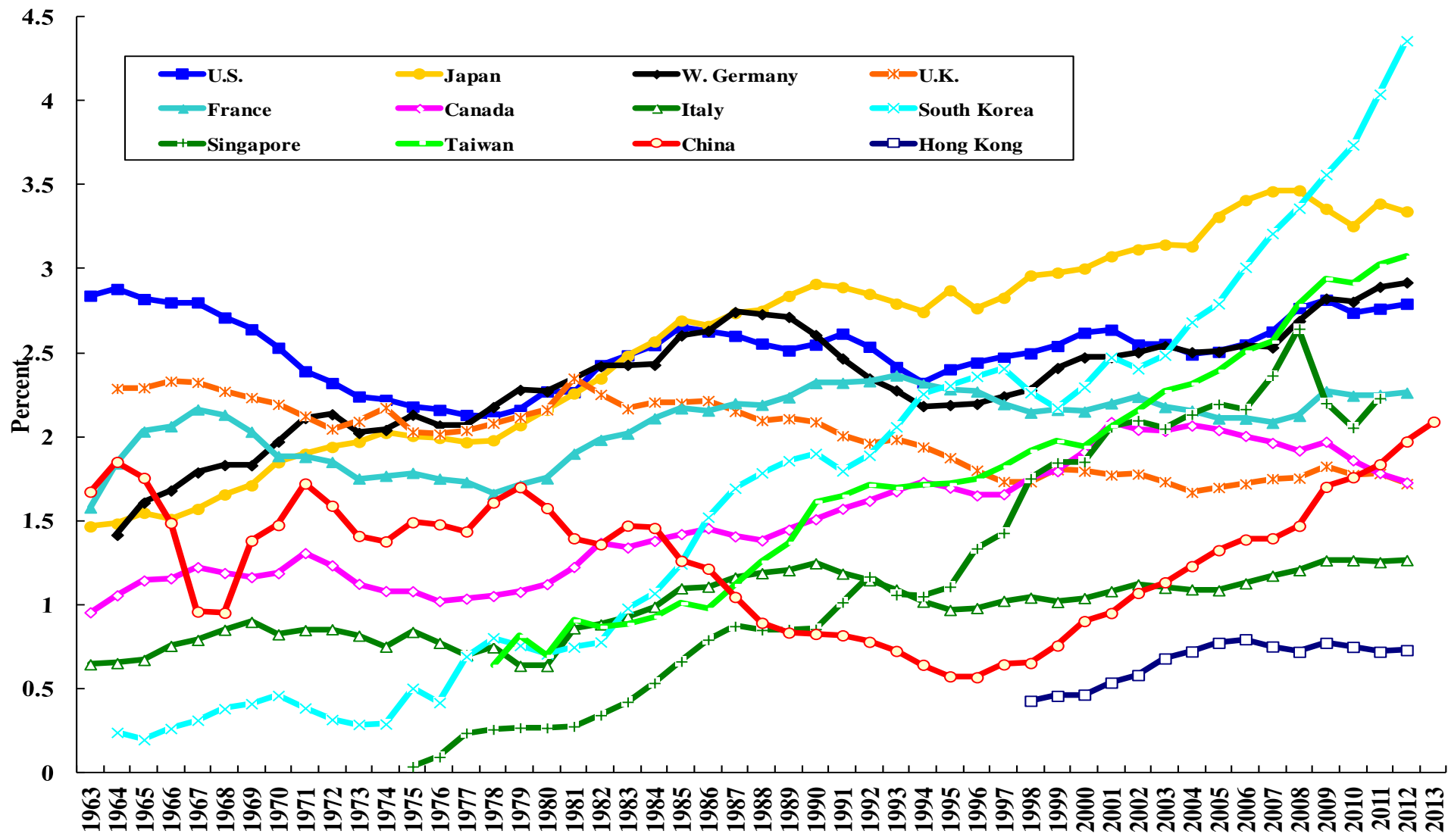
The On-Going Economic Challenges:

The Innovation Gap

- ◆ Investment in R&D capital is also important for promoting innovation (technical progress or equivalently growth in total factor productivity).
- ◆ China has also begun to invest more heavily in R&D in recent years—its R&D expenditure has been rising rapidly, both in absolute value, and as a percentage of GDP; but it 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.)
- ◆ The Republic of Korea currently leads the World with the percentage of its GDP expended on R&D exceeding 4%, followed by Japan, with an average ratio of 3% over the past quarter of a century.

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

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

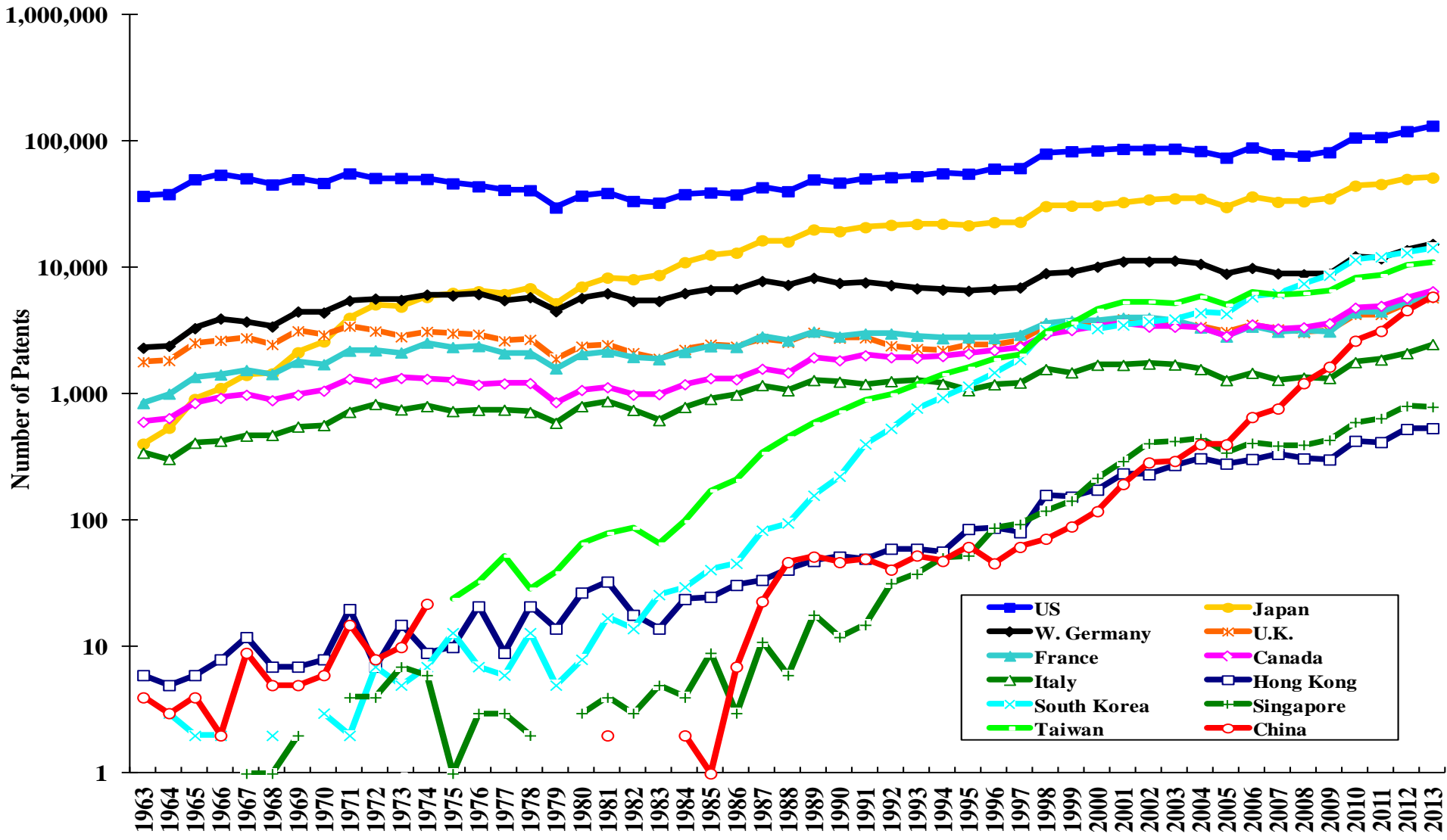


The On-Going Economic Challenges: The Innovation Gap

- ◆ One indicator of the potential for innovation (national innovative capacity) 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 133,593 patents granted in 2013, followed by Japan, with 51,919. (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.)

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

Patents Granted Annually in the United States: G7 Countries, 4 East Asian NIEs and China



The On-Going Economic Challenges: The Innovation Gap

- ◆ The number of patents granted to Chinese applicants each year has increased from the single-digit levels prior to the mid-1980s to 5,928 in 2013.
- ◆ The economies of South Korea and Taiwan, granted 14,548 and 11,071 U.S. patents respectively in 2013, are still far ahead of Mainland China—they have been averaging more than 10,000 patents a year each.

The On-Going Economic Challenges: The Innovation Gap

- ◆ The stock of R&D capital may be defined as the cumulative past real expenditure on R&D less depreciation of 10% per year. It should quite properly be treated as capital since R&D efforts generally take years to yield any results.
- ◆ Since China has had both a much lower R&D expenditure to GDP ratio and a much lower GDP than the United States and other developed economies in the past, it will take more than a couple of decades before the Chinese R&D capital stock can catch up to the level of U.S. R&D capital stock.

The On-Going Economic Challenges: The Innovation Gap

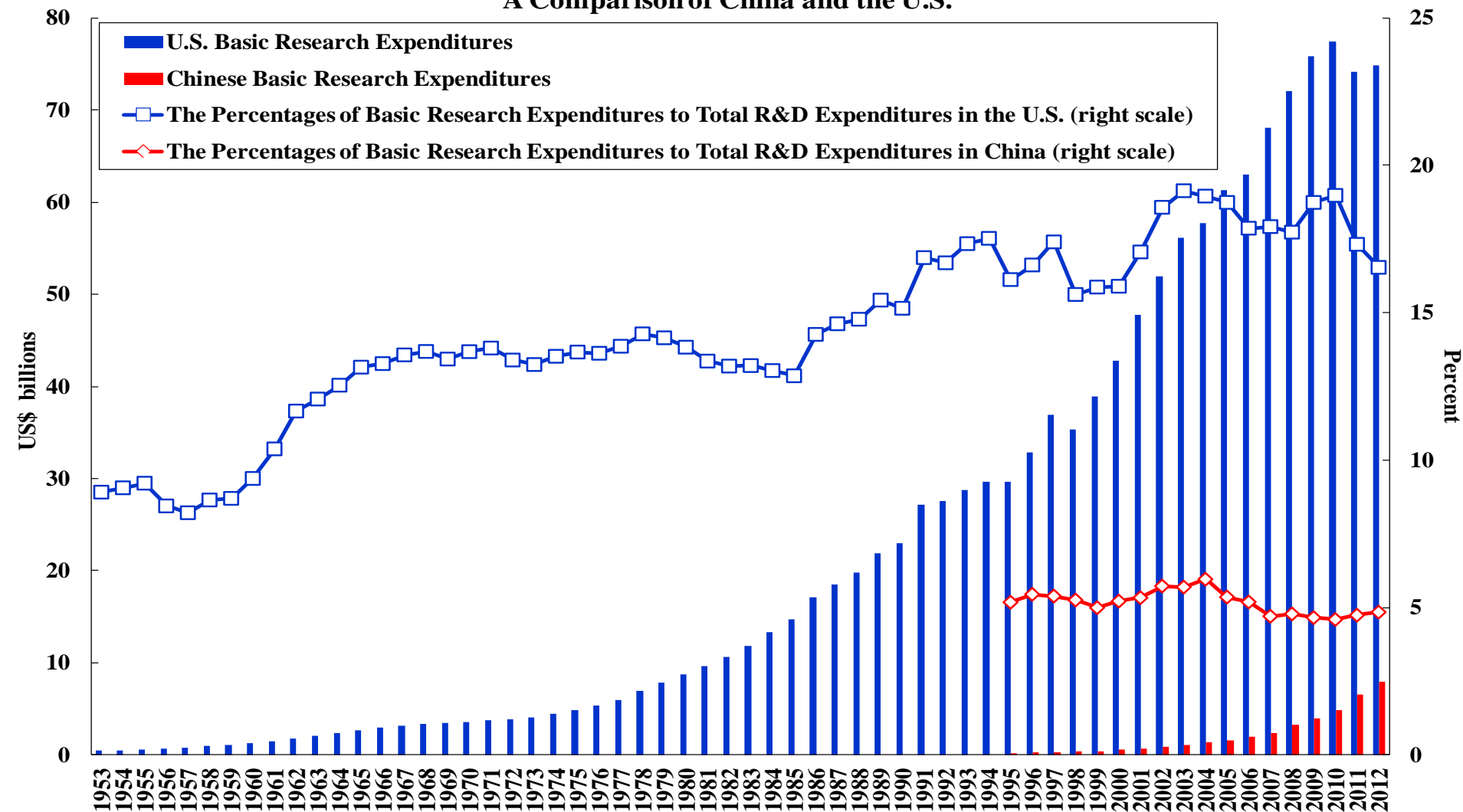
- ◆ The stock of R&D capital can be shown to have a direct causal relationship to the number of patents granted. (See the following chart, in which the annual number of U.S. patents granted is plotted against the R&D capital stock of that year for each economy).
- ◆ The chart shows clearly that the higher the stock of R&D capital of an economy, the higher is the number of patents granted to it by the U.S.
- ◆ It will take at least a couple of decades before the level of Chinese R&D capital stock can catch up to that of the U.S. and hence to the number of U.S. patents granted each year.

The On-Going Economic Challenges: The Innovation Gap

- ◆ Finally, in order that “break-through” innovation can occur, China must commit a much greater share of its R&D expenditure to the support of basic research, currently averaging 5%, compared to the share in the United States, which has averaged almost 20% over the past ten years. (See the following chart comparing the basic research expenditures between China and the U.S. in both absolute terms and as a percentage of total R&D expenditures).

Basic Research Expenditure and Its Share in Total R&D Expenditure: China & U.S.

Basic Research Expenditure and its Share in Total R&D Expenditure:
A Comparison of China and the U.S.



The On-Going Economic Challenges: The Excess Supply of Residential Real Estate

- ◆ There is an excess supply of residential housing in almost all cities in China. The situation is the worst in third- and fourth-tier cities. But even Beijing and Shanghai are not spared.
- ◆ Fortunately, the overall debt to equity ratio is approximately 20% for residential housing, so that even when the housing price bubble bursts, the impact will not be too severe.

The On-Going Economic Challenges: The Excess Supply of Residential Real Estate

- ◆ The housing price bubble is driven in part by the lack of good investment instruments and the repressed rate of interest on bank deposits, and in part by local government officials trying to increase local GDP and employment (which are their key performance indicators) through developing the land resources under their control. Thus, raising the rate of interest on bank deposits and introducing more financial instruments for investment can help to reduce the price level of residential real estate.
- ◆ If the housing price bubble bursts, its negative impact may be reduced by refinancing the owner-occupied residential housing loans with long-term fixed rate mortgage loans provided by a government policy bank.

The On-Going Economic Challenges: The Excess Supply of Residential Real Estate

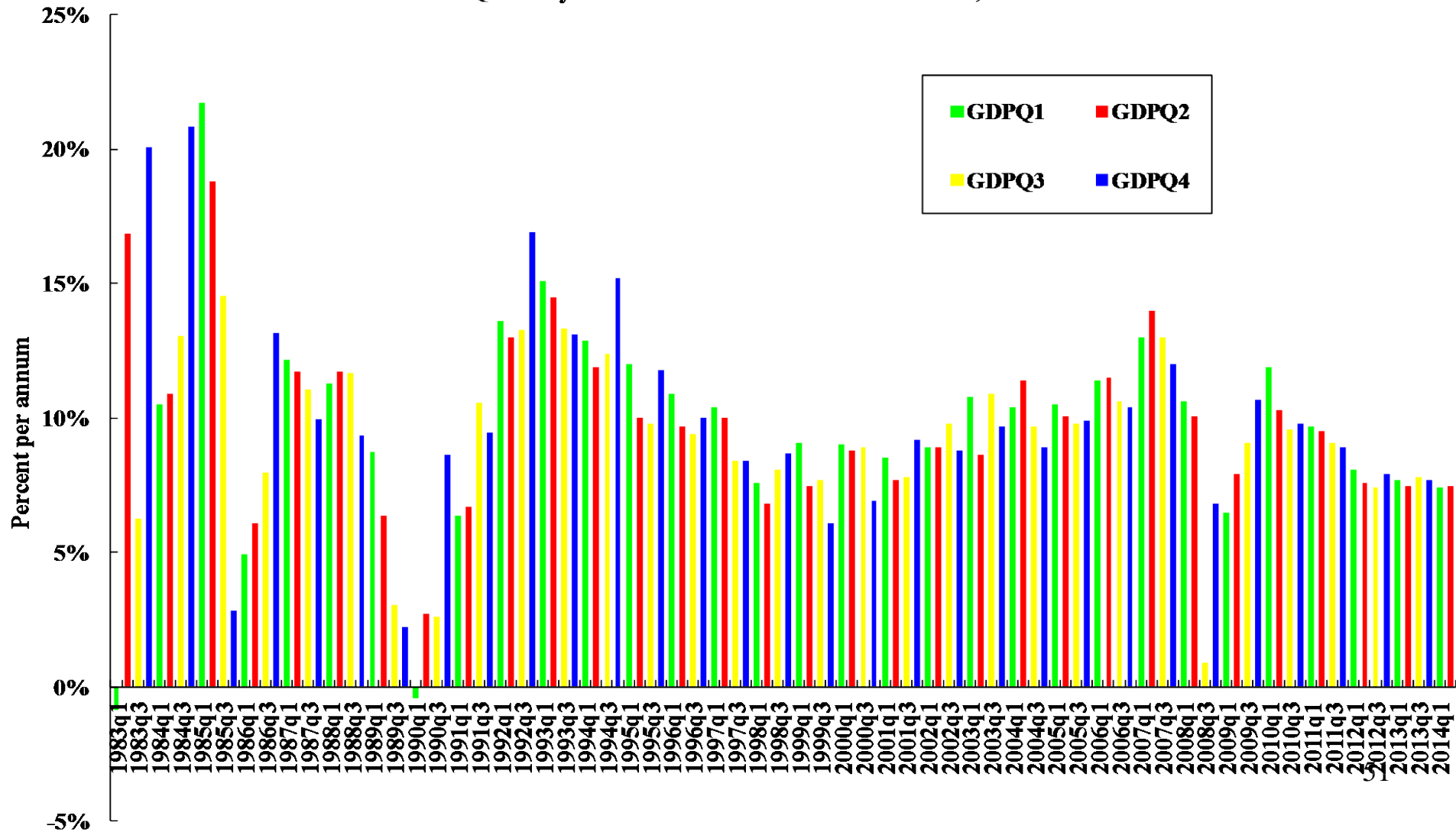
- ◆ The introduction of a property tax to be collected and used by the local governments should relieve some pressure on the local government officials to develop land under their control as a source of revenue.
- ◆ A change in the set of “key performance indicators” for the local government officials is necessary to change the emphasis from the growth of real GDP to the production and supply of public goods such as education, health care, and environmental control, preservation and restoration.

The Short-Term Economic Outlook: The Chinese Economy

- ◆ The Chinese economy grew 9.2% in 2009, 10.4% in 2010, 9.3 % in 2011, 7.7% in 2012 and 2013 even as the European and U.S. economies remained in recession. However, the slowdown is unmistakable but should be considered to be a positive development.
- ◆ In 2013Q3 and 2013Q4, the rates of growth of real GDP were 7.8% and 7.7%, Y-o-Y, respectively. In 2014 Q1 and 2014Q2, the rates of growth were 7.4% and 7.5%, Y-o-Y, respectively. All the short-term economic indicators suggest that the Chinese rate of growth has begun to stabilise between 7% and 8%. The target growth rate of the Chinese economy for 2014 is around 7.5%.
- ◆ The official target average growth rate for the Twelfth Five-Year Plan (2011-2015) period is a relatively modest 7%. A real rate of growth of over 7% per annum is definitely achievable for 2014.

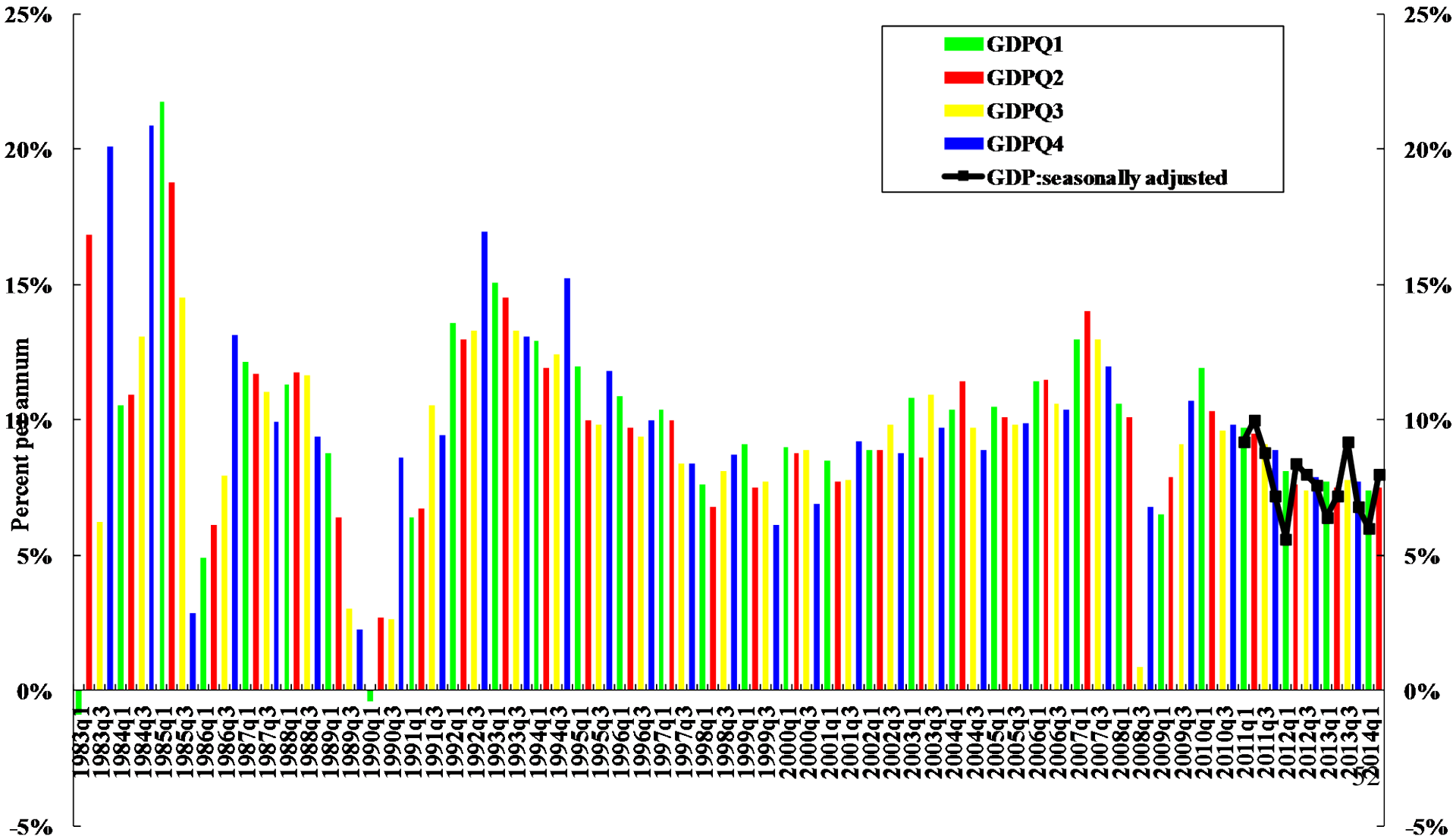
Quarterly Rates of Growth of Chinese Real GDP, Y-o-Y

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



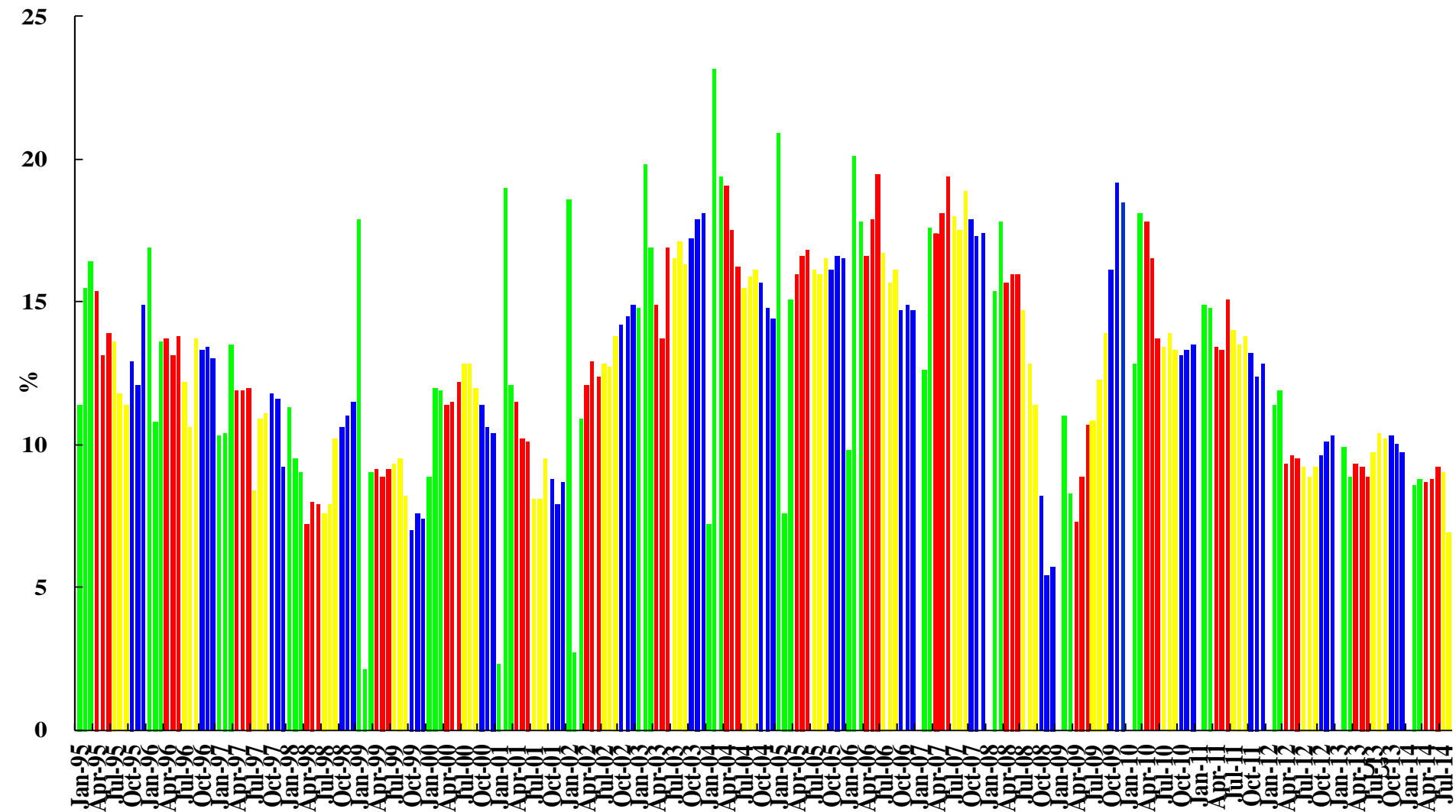
Quarterly Rates of Growth of Chinese Real GDP, Y-o-Y

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



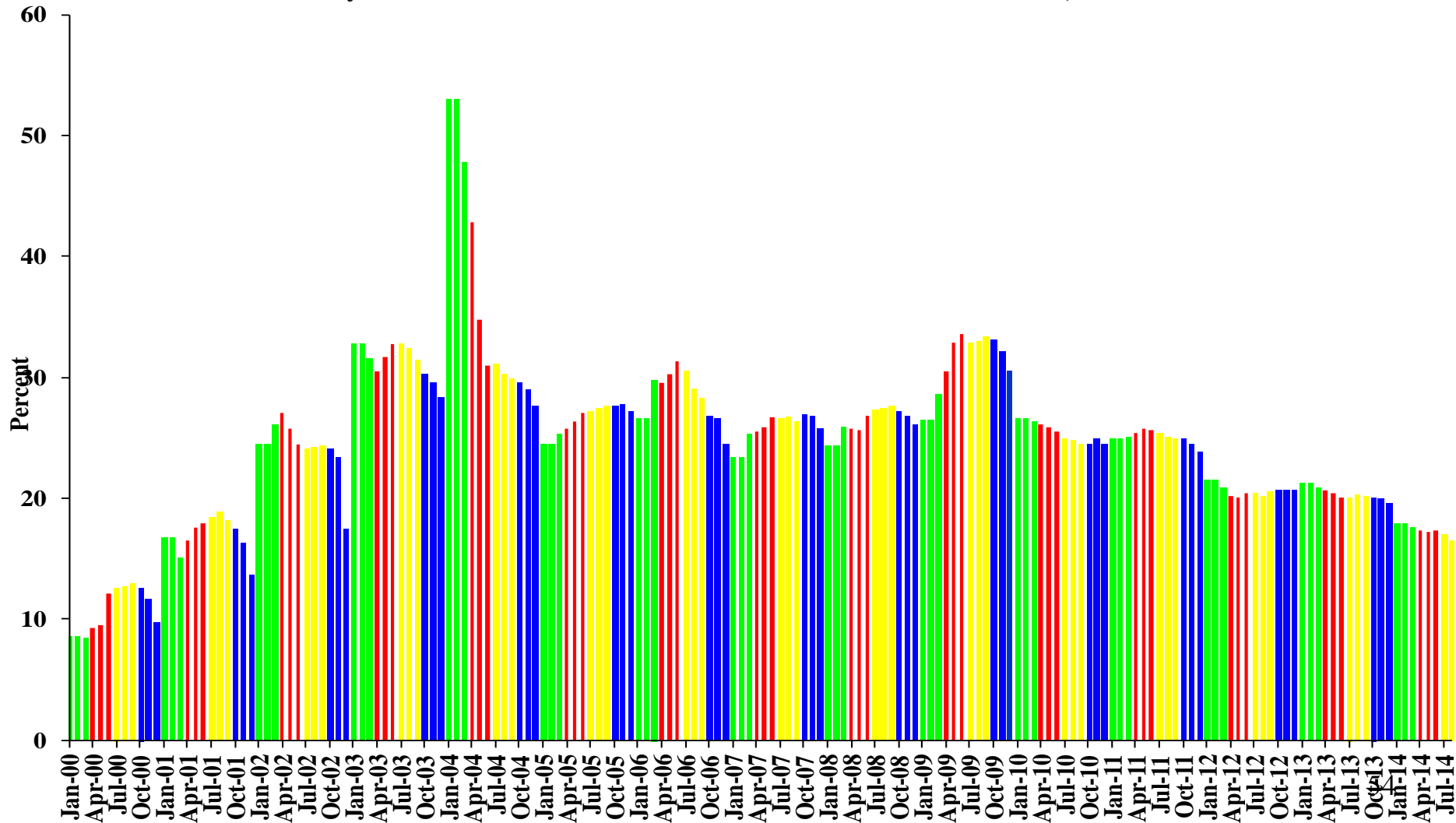
Monthly Rates of Growth of Real Value-Added of the Chinese Industry, Y-o-Y

Monthly Rates of Growth of Real Value-Added of the Industrial Sector, Year-over-Year



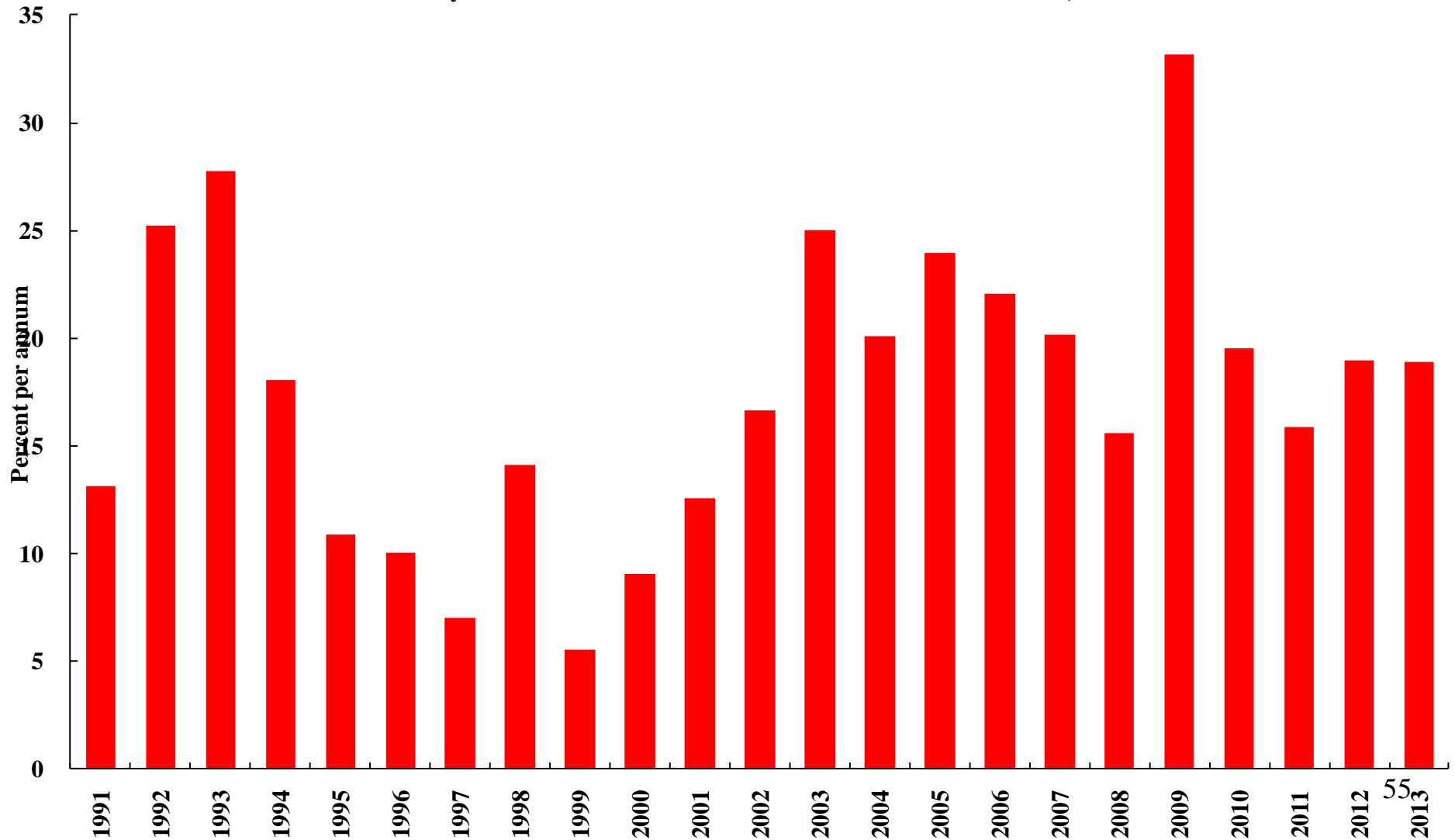
Monthly Rates of Growth of Chinese Fixed Assets Investment, Y-o-Y

Monthly Rates of Growth of Chinese Fixed Assets Investment since 2000, Year-over-Year



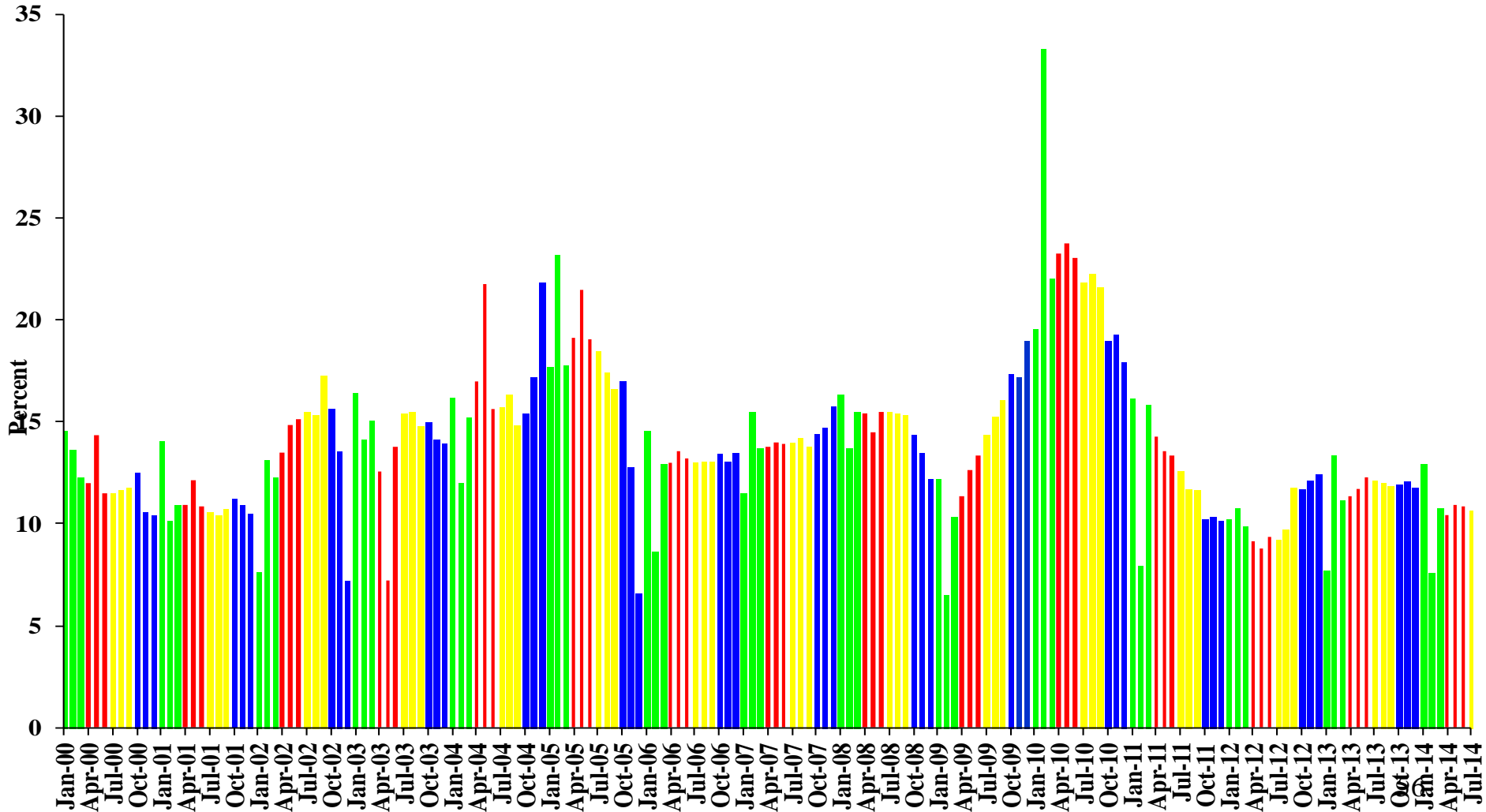
Annual Rates of Growth of Chinese Real Fixed Assets Investment, Y-O-Y

Annually Rates of Growth of Chinese Real Fixed Assets Investment, Y-O-Y



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

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



The Long-Term Economic Outlook

- ◆ Going forward, on the supply side, the Chinese economy has strong economic fundamentals: a high domestic saving rate, abundant labour, and a huge domestic market that enables the realisation of economies of scale.
- ◆ In time, Chinese economic growth will also be driven by innovation and technical progress in addition to the growth in tangible inputs.
- ◆ On the demand side, Chinese economic growth will be driven by the growth of its own internal demand, consisting of public infrastructural investment (for example, high-speed railroads and mass transit systems, affordable housing), public goods consumption (education, health care and environmental control, preservation and restoration) as well as household consumption, rather than the growth of exports or fixed investment in the manufacturing sector.

The Long-Term Economic Outlook

- ◆ In the medium term, say five years, economic stimulus is unlikely to be inflationary because of the excess manufacturing capacities already in place, especially if the economic stimulus is carefully targeted.
- ◆ In the longer term, there is still a great deal of room for Chinese GDP to grow. There is still significant surplus labour. Both the tangible capital and the intangible capital per unit labour are still relatively low. There is substantial scope for improvement in human capital and R&D capital.

The Metaphor of the “Wild Geese Flying Pattern”

- ◆ The metaphor of the "wild-geese-flying pattern" of East Asian economic development over time, introduced by Professor Kaname Akamatsu (1962), suggests that industrialisation will spread from economy to economy within East Asia 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, and need to relocate some of its industries to lower-cost economies. The fastest-growing economy will thus slow down and the lower-cost economy will take over as the fastest-growing economy.

The Metaphor of the “Wild Geese Flying Pattern”

- ◆ Thus, East Asian industrialisation spread from Japan to first Hong Kong in the mid-1950s, and then Taiwan in the late 1950s, and then South Korea and Singapore in the mid-1960s, and then Southeast Asia (Thailand, Malaysia, Indonesia) in the 1970s, and then to Guangdong, Shanghai, Jiangsu and Zhejiang in China as China undertook economic reform and opened to the World beginning in 1978.
- ◆ 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, quality assurers, and managers of logistics and supply chains.

The Metaphor of the “Wild Geese Flying Pattern”

- ◆ This metaphor actually applies not only to East Asia but also to China itself because of its large size. Within China, industrialisation first started in the coastal provinces, autonomous regions and municipalities and then would migrate and spread to other provinces, regions and municipalities in the interior—to Chongqing, Henan, Hunan, Jiangxi, Shaanxi and Sichuan—as real wage rates rose on the coast. As the coastal provinces, regions and municipalities began to slow down in their economic growth, the provinces, autonomous regions and municipalities in the central and western regions of China would take their turns as the fastest growing areas in China. China as a whole will therefore be able to maintain a relatively high rate of growth for many years to come.

Concluding Remarks

- ◆ The highly successful experience of Chinese economic growth over the past 36 years (as well as those of other East Asian economies) strongly reaffirm the fundamental importance of having and maintaining a high investment rate, enabled by a high national savings rate, and surplus labour.
- ◆ In addition, the size of the Chinese domestic economy is a favourable factor allowing the ready realisation of economies of scale and reducing vulnerability to external disturbances.
- ◆ However, these favourable factors alone were not sufficient, as the Chinese economy did not experience sustained economic growth between 1949 and 1978.

Concluding Remarks

- ◆ Economic reform and opening allowed the realisation of the huge surplus potential output, helped to enhance and assure the efficiency of the Chinese economy and facilitated technology transfer from abroad.
- ◆ It is the unique achievement of China that in its transition from a closed centrally planned economy to an open market economy, it was able to use a strategy of “reform without losers”--making sure that no one would be worse off. Such a strategy maximised support, minimised opposition and preserved social stability. It led to win-win for all. As a result, the Chinese transition was smooth, stable and successful.

Concluding Remarks

- ◆ Continuing Chinese economic growth going forward will depend mostly on the growth of internal demand (infrastructural investment, public goods consumption (education, health care and environmental control, preservation and restoration) and household consumption) and not on exports and not on manufacturing capacity expansion in the existing industries.

Concluding Remarks

- ◆ China is a large continental country like the United States and will similarly develop into a largely internal-demand driven economy. International trade and international investment will not have a decisive impact on the Chinese economy in the future. Eventually, Chinese exports as a percent of its GDP should be relatively low, in the teens.
- ◆ 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.

Concluding Remarks

- ◆ Given the huge excess capacities in the Chinese manufacturing industries, in the time frame of the next five to ten years, Chinese GDP, as mentioned above, will not be supply-constrained but will be primarily determined by aggregate demand. China should have no problem achieving a rate of real economic growth of around 7%.
- ◆ Beyond that, on the basis of its strong economic fundamentals, China should also be able to continue to grow at an average annual rate of at least 7% for the following decade, more or less independently of what happens in the rest of the World.

Concluding Remarks

- ◆ The new “normal” is thus neither a “boom” of close to double-digit rates of growth, nor a “bust” of negative or low single-digit real rates of growth. There will be both sufficient supply and demand in the Chinese economy to support an average real rate of growth of 7%.