Recent Developments in the Chinese Economy

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

CCVP Fund LP and Advisory Committee Annual Meeting
16 November, 2015
Shangri-La Hotel, Fuzhou City, Fujian, China

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

*All opinions expressed herein are the author's own and do not necessarily reflect the views of any of the organizations with which the author is affiliated.

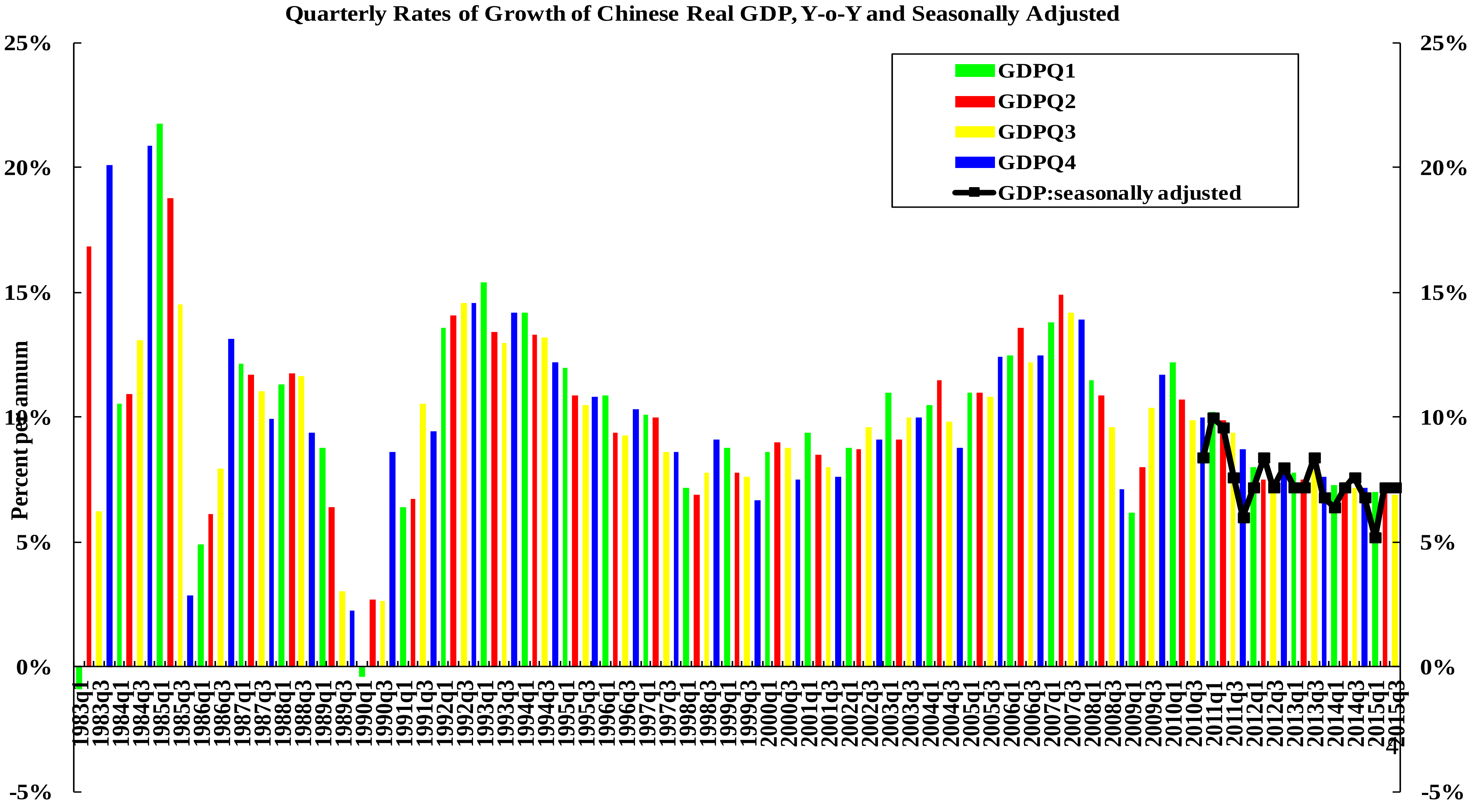
Outline

- The Transition to a “New Normal” and the Thirteenth Five-Year (2016-2020) Plan
- The Unimportance of the Stock Market
- The Internationalization of the Renminbi
- Concluding Remarks

The Transition to a "New Normal" and the Thirteenth Five-Year (2016-2020) Plan

- Going forward, will the Chinese economy continue to grow at close to 10 percent per annum in the future? The short answer is no, for many reasons. The target rate of growth under the "New Normal" is likely to be 6.5 percent per annum as indicated in the Thirteenth Five-Year Plan.
- Since 2013, the Chinese economy has been in the process of transitioning to a "New Normal". The rate of growth of the Chinese economy has since been slowing down gradually from double-digit rates to 7.7% in 2013 and 7.3% in 2014 and is expected to grow around 7% in 2015, which is in accord with the Chinese plan.
- In 2015Q1, 2015Q2 and 2015Q3, the annualized rates of growth were respectively 7.0%, 7.0% and 6.9% ,Y-o-Y. Seasonally adjusted, they were 5.6%, 6.8% and 7.2% respectively. The economic performance in 2015Q3 is above expectations because industries were closed down for a couple of weeks in the regions surrounding Beijing to ensure a clear sky and clean air for the World Track and Field Meet and for the 70th Anniversary of the Victory of World War II in the Asia-Pacific Military Parade.

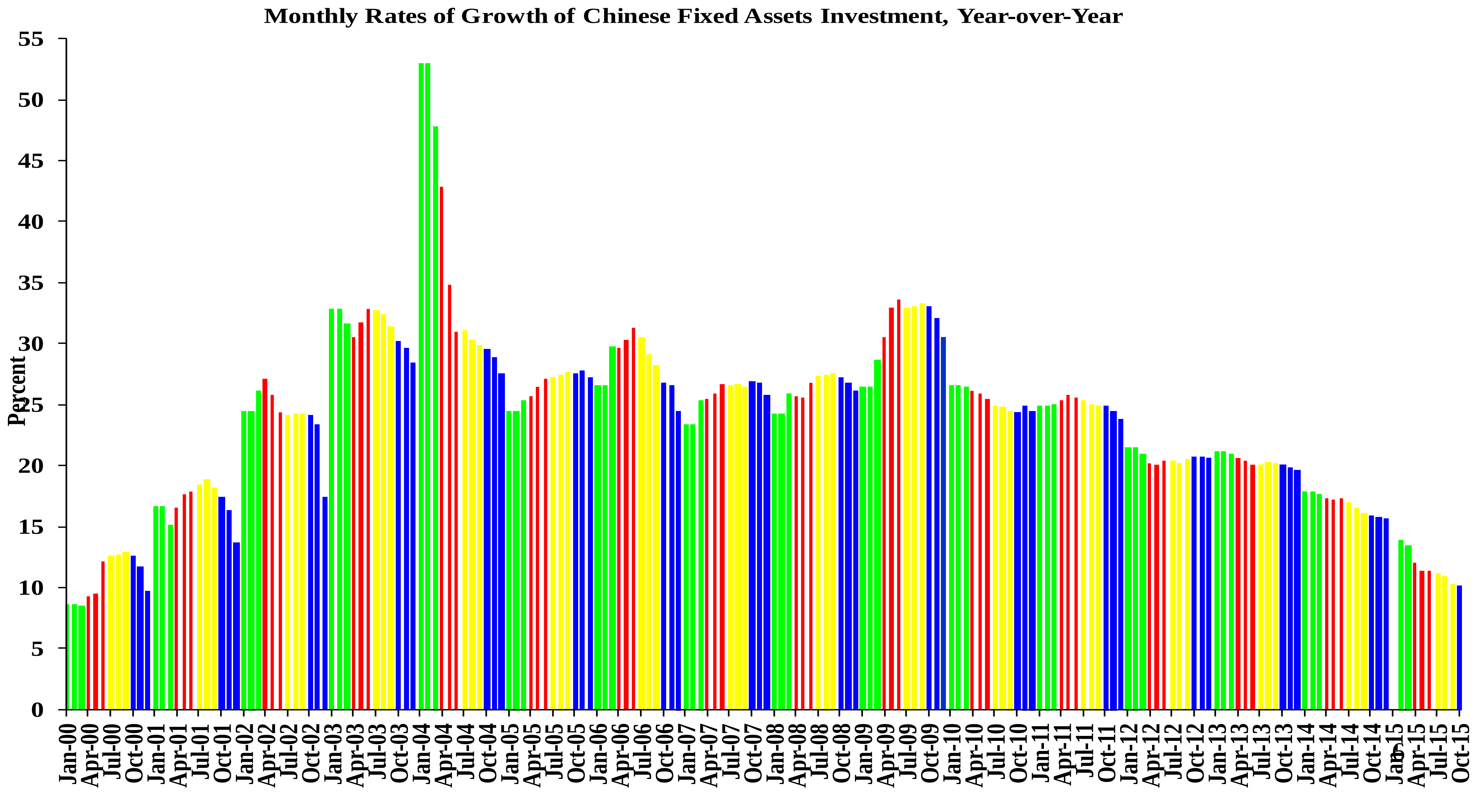
Quarterly Rates of Growth of Chinese Real GDP, Y-o-Y and Seasonally Adjusted



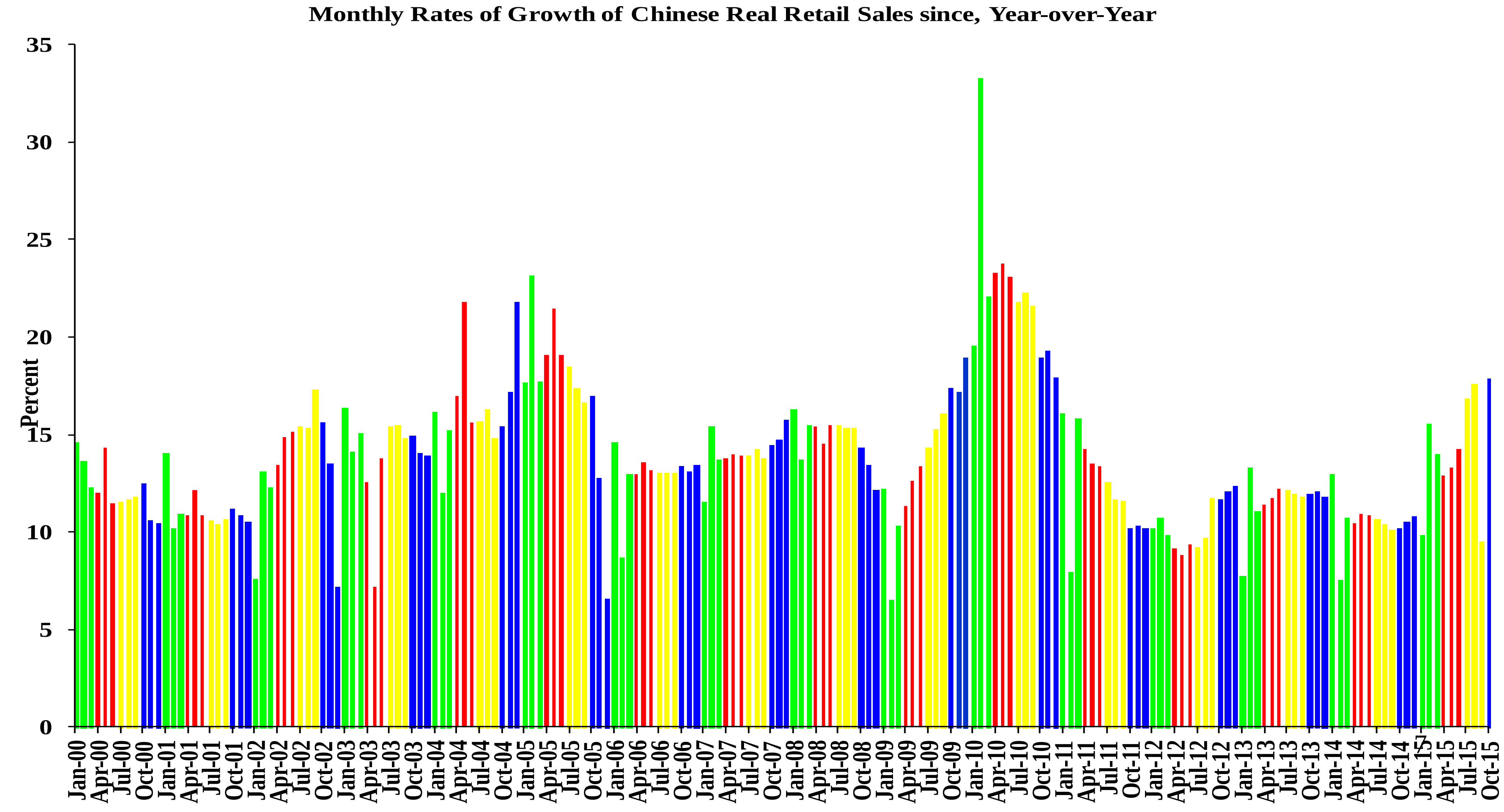
The Transition to a “New Normal” and the Thirteenth Five-Year (2016-2020) Plan

- The rate of growth of fixed asset investment has been declining, reflecting, in part, that the expectation that the rate of growth of real GDP will decline from almost 10% to around 6.5% going forward, and in part the changing composition of GDP with the service sector, which requires much less fixed asset investment, becoming the largest sector of the economy (48.2% in 2014).
- However, the expectations of the consumers appear to have remained positive. The rate of growth of real retail sales has continue to rise at approximately one and a half times the rate of growth of real GDP.
- The target growth rate of the Chinese economy for 2015 is around 7%. The actual rate of growth for the year as a whole is likely to be somewhere between 6.5% and 7%.

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



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



The Transition to a “New Normal”: Trading Quantity for Quality

- What does the ”New Normal” imply?
- First, there will be a reduction of the rate of growth of the measured real GDP, from almost 10% to perhaps just around 6.5% per annum, but with a greater emphasis on the “quality” of the economic growth, including the preservation, protection, restoration and enhancement of the environment and improvement of access to education, health care and elderly care, which are not necessarily reflected in the GDP as conventionally measured.

The Transition to a "New Normal": Trading Quantity for Quality

- The key performance indicators for the local government officials will be changed so that long-term economic viability and sustainability are also taken into account in addition to short-term growth in real GDP and employment.
- Moreover, other key performance indicators, such as those on the environment, both globally and locally, for example, air and water quality, should also be included. The improvement of energy efficiency and the reduction of carbon emission are also important areas of focus.
- It is believed that these key performance indicators which relate to the quality of growth will also be reflected in the targets of the Thirteenth Five-Year Plan.

The Transition to a “New Normal”: Transformation of Supply Composition

- Second, there will be a transformation in the composition of GDP by production sectors.
- The tertiary sector has already overtaken the secondary sector as the most important sector by GDP originating. It accounted for more than 52% of GDP in 2015H1. The GDP originating from the primary (agricultural) sector fell below 9.2% in 2014.
- The shift in the sectoral composition has led to changes in the demands for energy, including electricity, transportation, and fixed investment. Thus, while the so-called “Keqiang Index”, which consists of the weighted sum of rates of growth of electricity consumption, railroad freight volume and bank credit may have been a good indicator of the rate of growth of the industrial sector, it will be an increasingly downward-biased indicator of the rate of growth of real GDP because of the continuing shift in sectoral composition towards the tertiary or service sector.

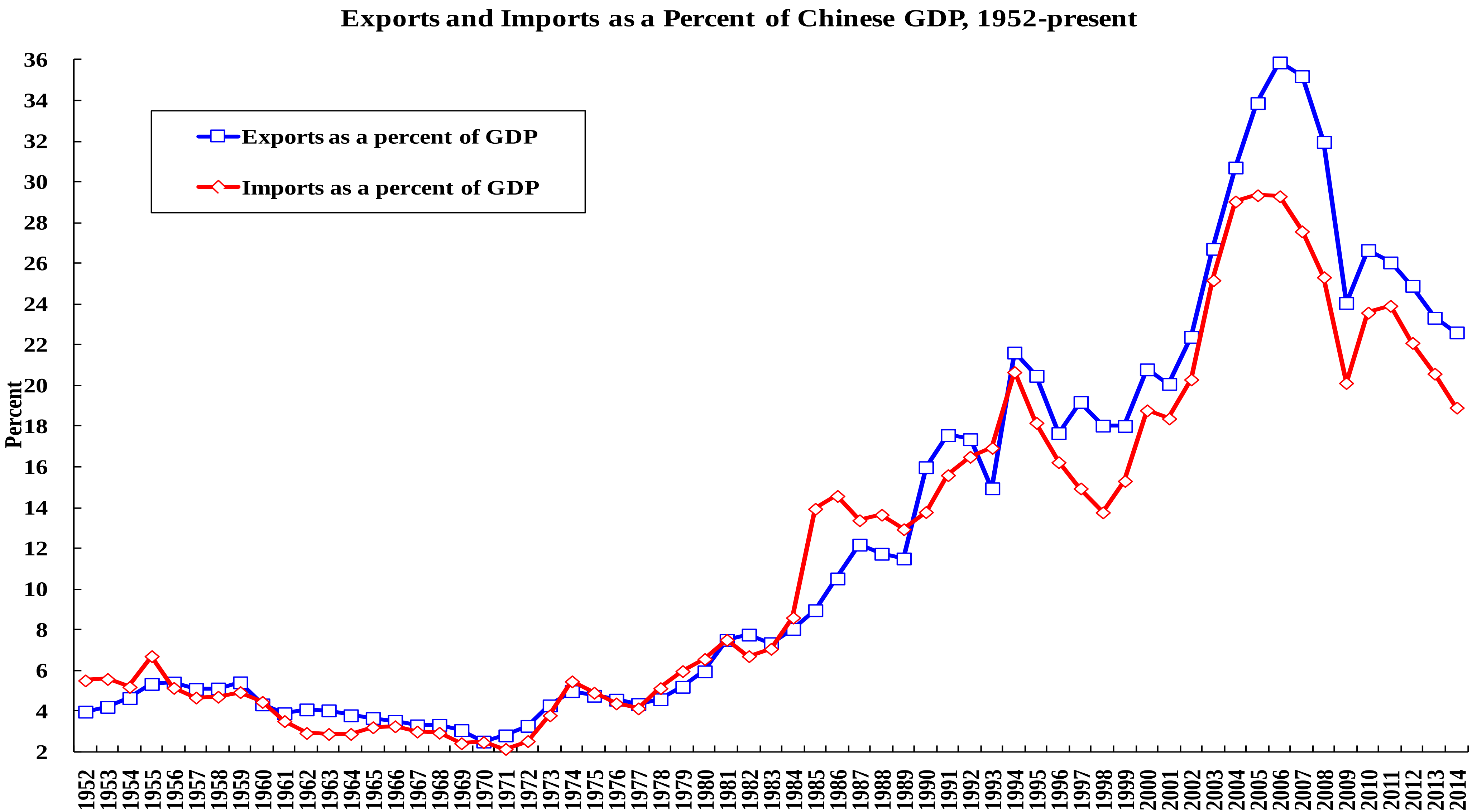
The Transition to a "New Normal": Transformation of Supply Composition

- The principal challenge facing the Chinese economic policy makers is not so much the growth of real GDP but employment.
- The service sector (48.2% by GDP and 40.6% by employment in 2014) is now larger and growing faster than the industrial sector (42.6% by GDP and 29.9% by employment in 2014).
- In 2013 and 2014 respectively, 13 million and 10 million new jobs were created. An expansion of the service-sector GDP creates 30% more employment than an expansion of industrial sector GDP of the same magnitude and requires much less fixed investment as well as energy. Thus, the shift in sectoral composition in favor of the service sector will raise the employment/GDP ratio and lower the energy/GDP ratio.
- It will also lead to reductions in the rates of growth of Chinese demands for imports of natural resources from around the World.
- The growth of the service sector has been and will continue to be driven by rising urbanization in China.

The Transition to a "New Normal": Transformation of Final Demand Composition

- Third, there will be a transformation in the composition of final demand . On the demand side, Chinese economic growth will be principally driven by the growth of its own internal demand, consisting of public infrastructural investment (for example, high-speed railroads, urban mass transit systems and other urban public works, public wifi towers, affordable housing, other urban public works, clean energy), public goods consumption (education, health care, elderly care, and environmental protection, preservation and restoration—clean air, water and soil) as well as household consumption. It will no longer be driven by the growth of exports, or fixed investment in the manufacturing sector, or residential real estate.
- However, it should be noted that while the gross value of exports may not grow very fast any more, and will be a declining share of GDP, the value-added of exports may actually grow faster than the gross value itself. After all, it is the value-added that counts, not the gross value.

Exports and Imports as a Percent of Chinese GDP, 1952-present



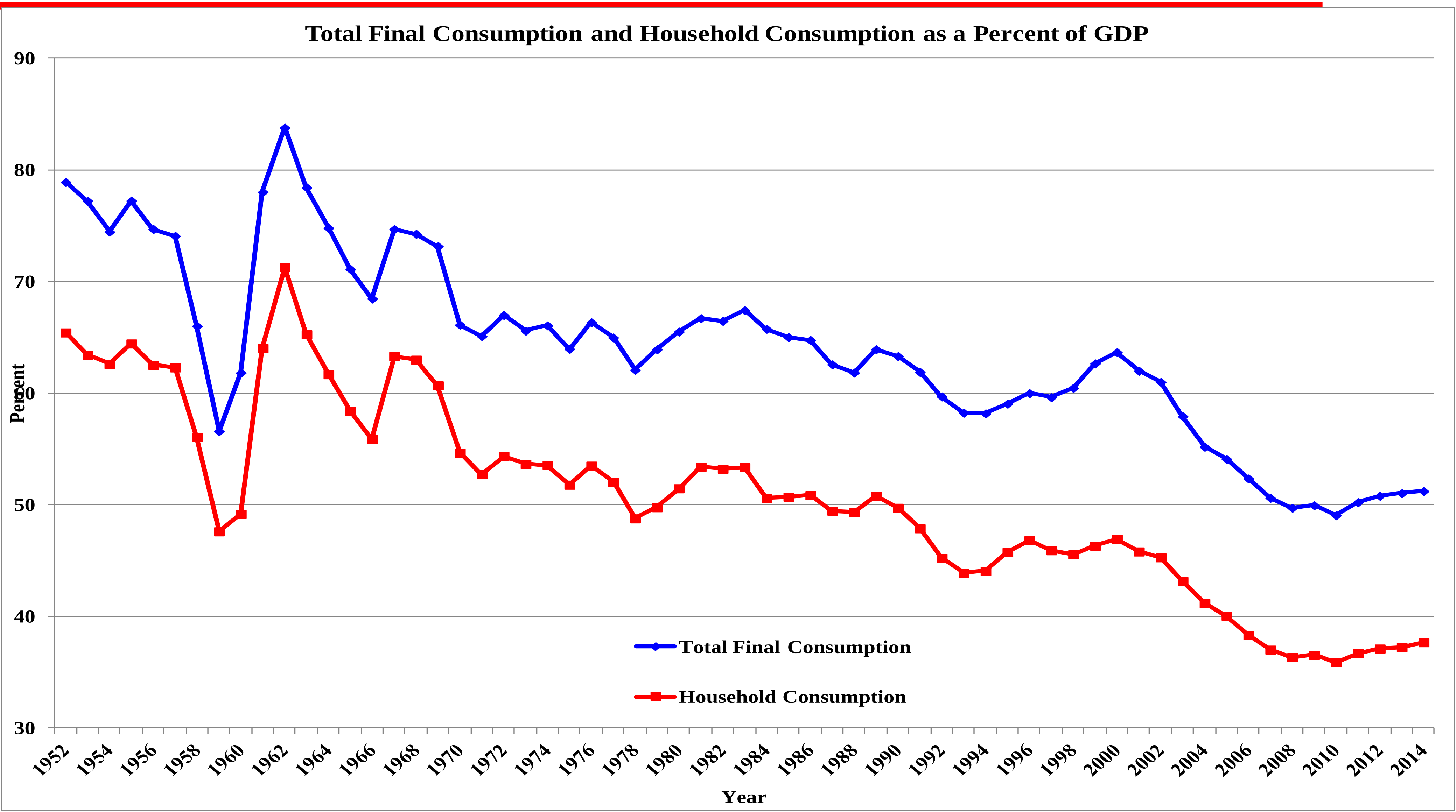
The Transition to a "New Normal": Transformation of Final Demand Composition

- Urbanisation can not only increase the demand for public infrastructure and housing, but also promote the growth of the service sector, on both the supply and the demand sides.
- The growth in public goods consumption (including necessary related investments) such as education, health care, care for the elderly, and environment protection, preservation and restoration--securing cleaner air, water and soil can and should be an important component of the growth of aggregate demand going forward.
- Increasing public goods consumption is an effective method of redistribution in kind. For example, since everyone breathes the same air, if the air is cleaner, both the wealthy and the poor benefit equally; and better access to health care may benefit the lower-income households more. Expansion of public goods consumption can thus reduce the real income disparity significantly.

The Transition to a "New Normal": Transformation of Final Demand Composition

- The share of household consumption in GDP was approximately 38% in 2014. It will be a while before Chinese household consumption can become the major driver of Chinese economic growth. The share of disposable household income in Chinese GDP may be estimated to be around 50% in 2014. Even if the households consume its entire disposable income, household consumption cannot exceed 50% of GDP, compared to between 65% and 70% for developed economies.
- Delinking of the salaries between the government sector and the enterprise sector as well as increasing cash dividend payments by publicly listed enterprises may be helpful in increasing household income and hence household consumption.

Total Chinese Final and Household Consumption as a Percent of Its GDP



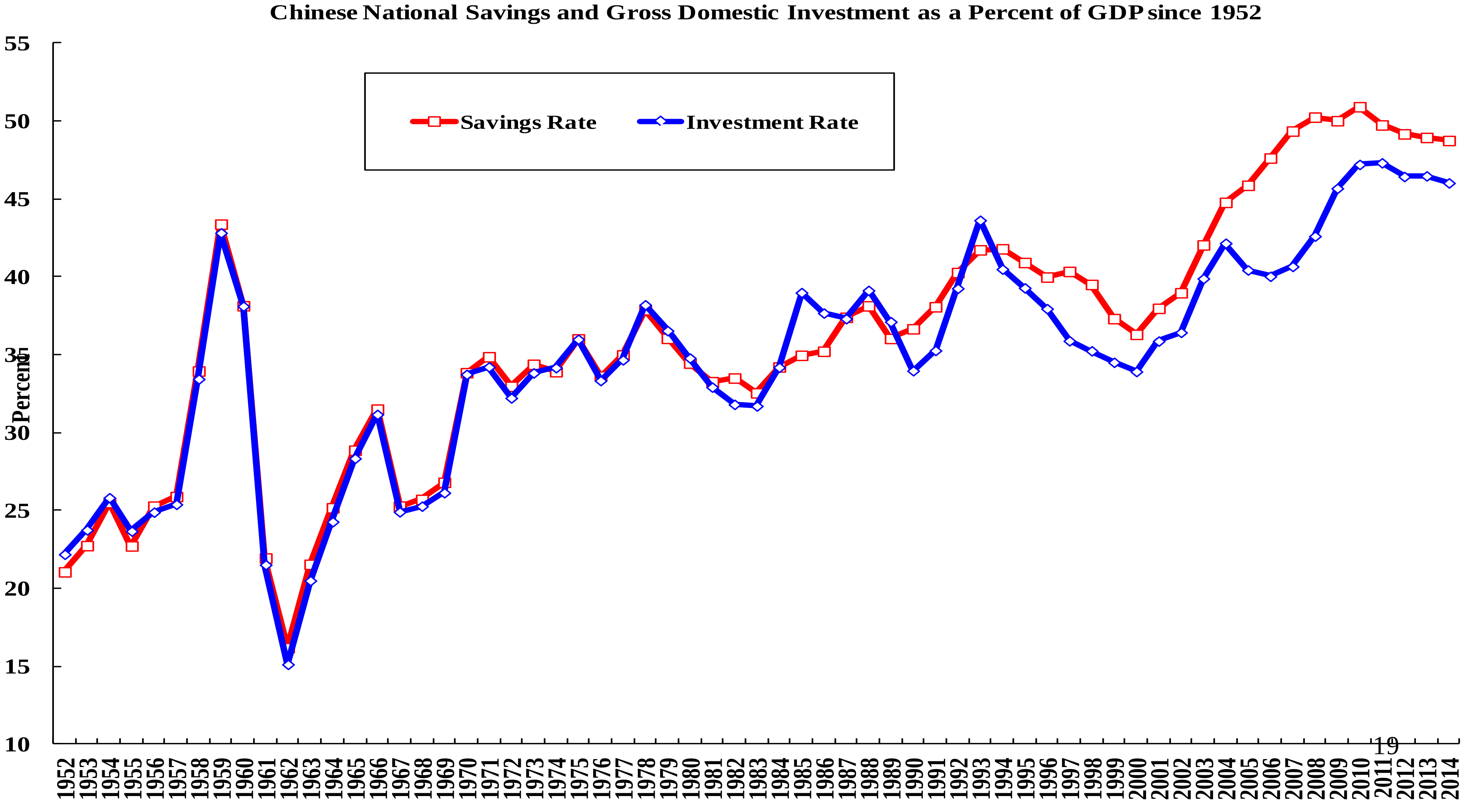
The Transition to a “New Normal”: Transformation of the Sources of Growth

- Fourth, there will be a gradual transformation of the sources of growth, from the growth of tangible inputs such as structures, equipment, and labor, and infrastructural investment, to the growth of intangible inputs such as human capital and R&D capital.
- Past economic growth has been mostly driven by the growth of tangible capital. Technical progress or growth of total factor productivity accounts for less than 10 percent of Chinese economic growth since 1978.

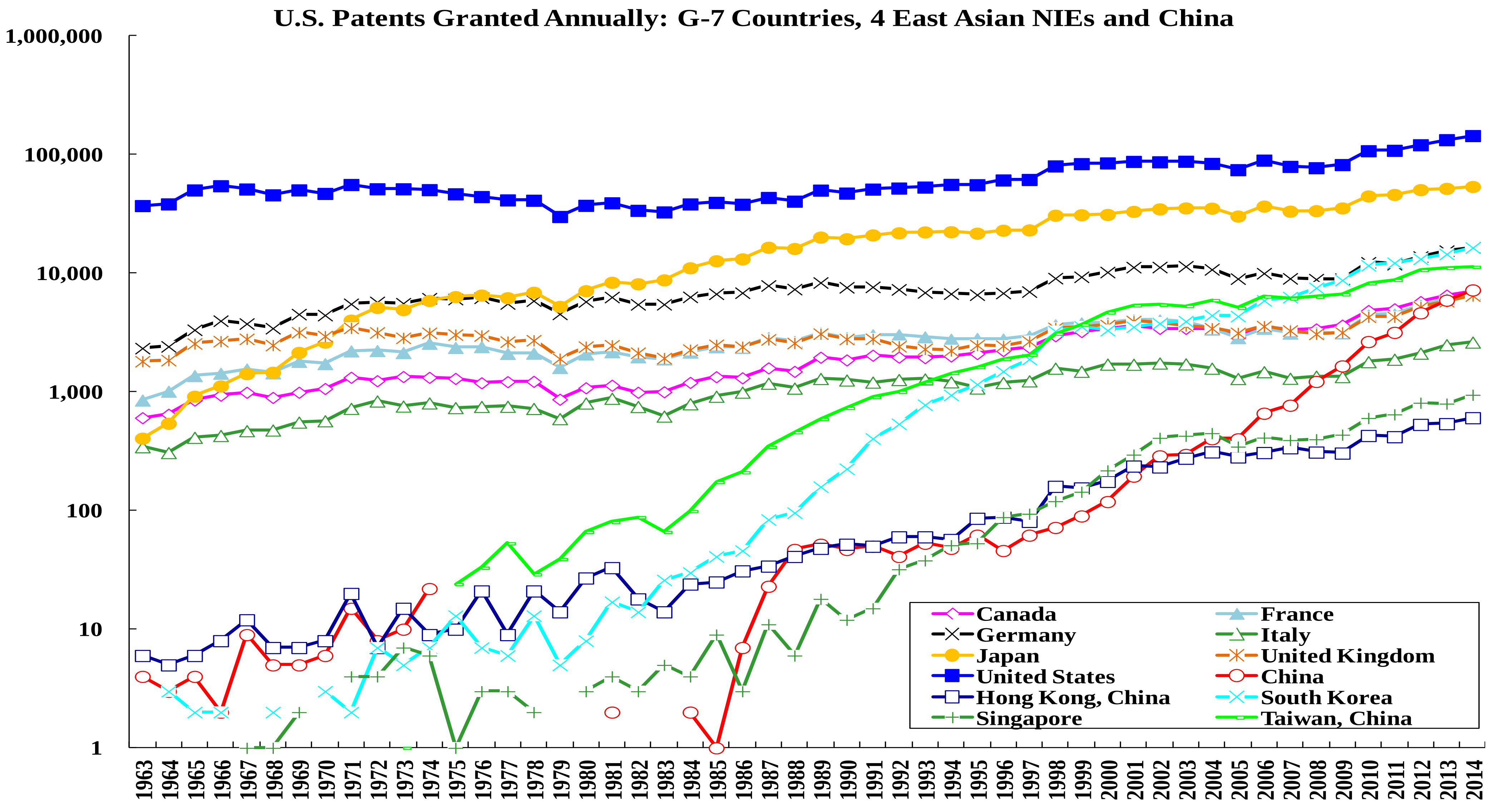
The Transition to a “New Normal”: Transformation of the Sources of Growth

- The Chinese economy will still have strong economic fundamentals--a high domestic saving rate, abundant labor, and a huge domestic market that enables the realisation of economies of scale—for a couple of decades. Moreover, advances in the information and communication technology has enhanced the positive effects of economies of scale even further.
- Investment in human capital and R&D has been increasing rapidly, even though both the stocks of human capital and R&D capital still lag significantly behind those of the U.S. and Japan, especially on a per capita basis.
- In time, Chinese economic growth will also be driven by innovation and technical progress in addition to the growth in tangible inputs.

Chinese National Saving and Gross Domestic Investment as Percents of GDP



Annual Number of U.S. Patents Granted: Selected Economies



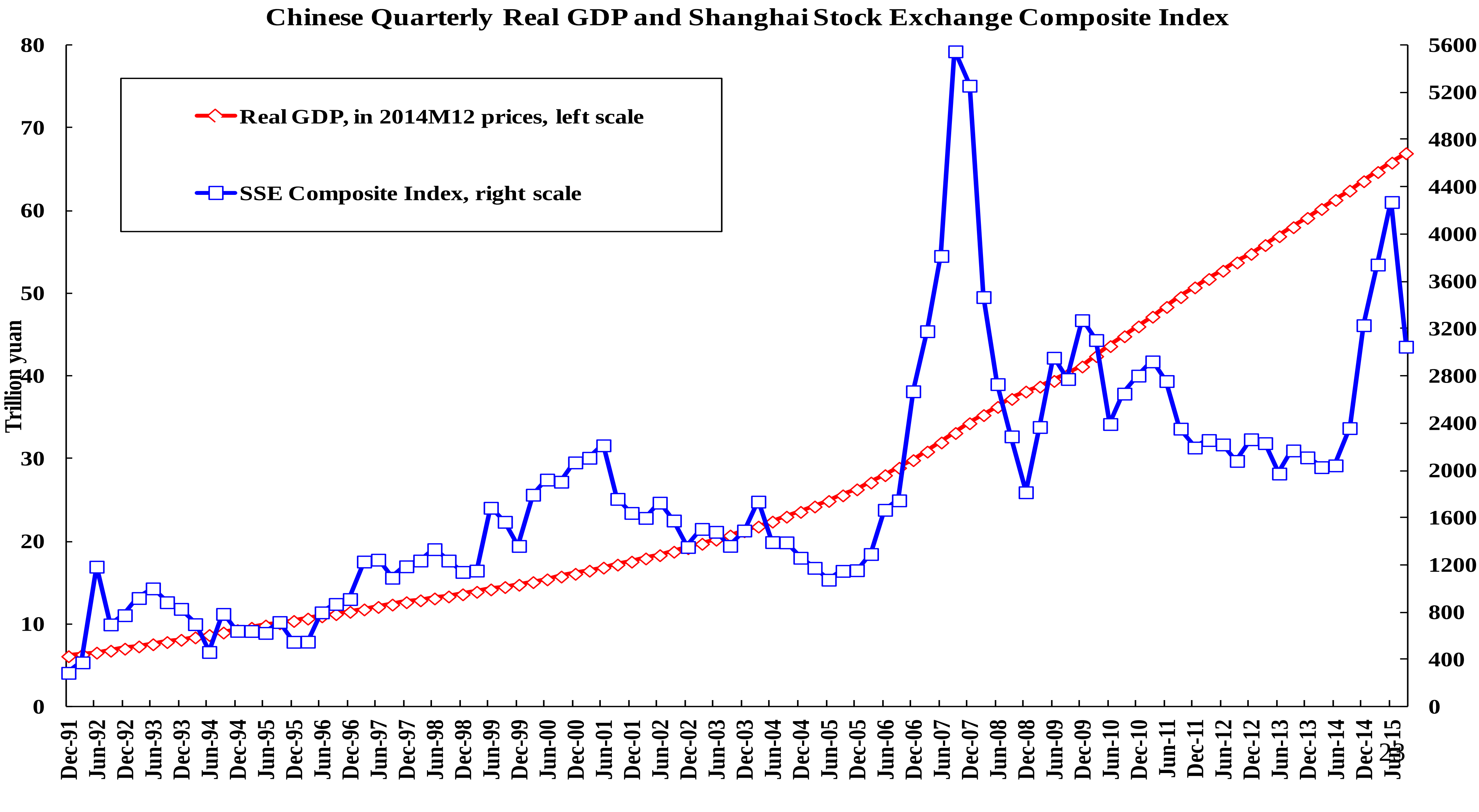
The Transition to a “New Normal”: Transformation of the Sources of Growth

- The “Made in China 2025“ plan recently announced by the State Council is designed to transform China into a world manufacturing power comparable to Germany and Japan today.
- The 10 key sectors that are the foci of “Made in China 2025“ plan are new information technology, numerical control tools and robotics, aerospace equipment, ocean engineering equipment and high-tech ships, railway equipment, energy saving and new energy vehicles, power equipment, new materials, biological medicine and medical devices, and agricultural machinery.

The Unimportance of the Stock Market

- What is the impact of the bursting of the Chinese stock market bubble in June 2015 on the Chinese economy itself? It should be realized that this is not the first time that a Chinese stock market price bubble burst. It happened once before, in 2007, when the peak of the bubble was higher and the trough was lower than the current one (see the following chart). However, neither the run-up of the stock price bubble, or its subsequent burst, appeared to have much effect on the Chinese real economy.
- Why is this the case? One reason is that approximately 90 percent of the Chinese stock investors are individual retail investors, who tend to hold their shares for only brief periods, and trade very often. It is probably more accurate to describe their behavior as "gambling" rather than "investing". Moreover, for the longest time, "Initial Public Offerings (IPOs)" were suspended on Chinese stock markets. Thus, the developments in the real economy and the stock market are uncorrelated. The next two charts also shows that the real rates of growth of the Chinese economy are basically uncorrelated with the rates of growth of the Shanghai Composite Stock Price Index.

The Chinese Quarterly Real GDP and the Shanghai Stock Exchange Composite Index

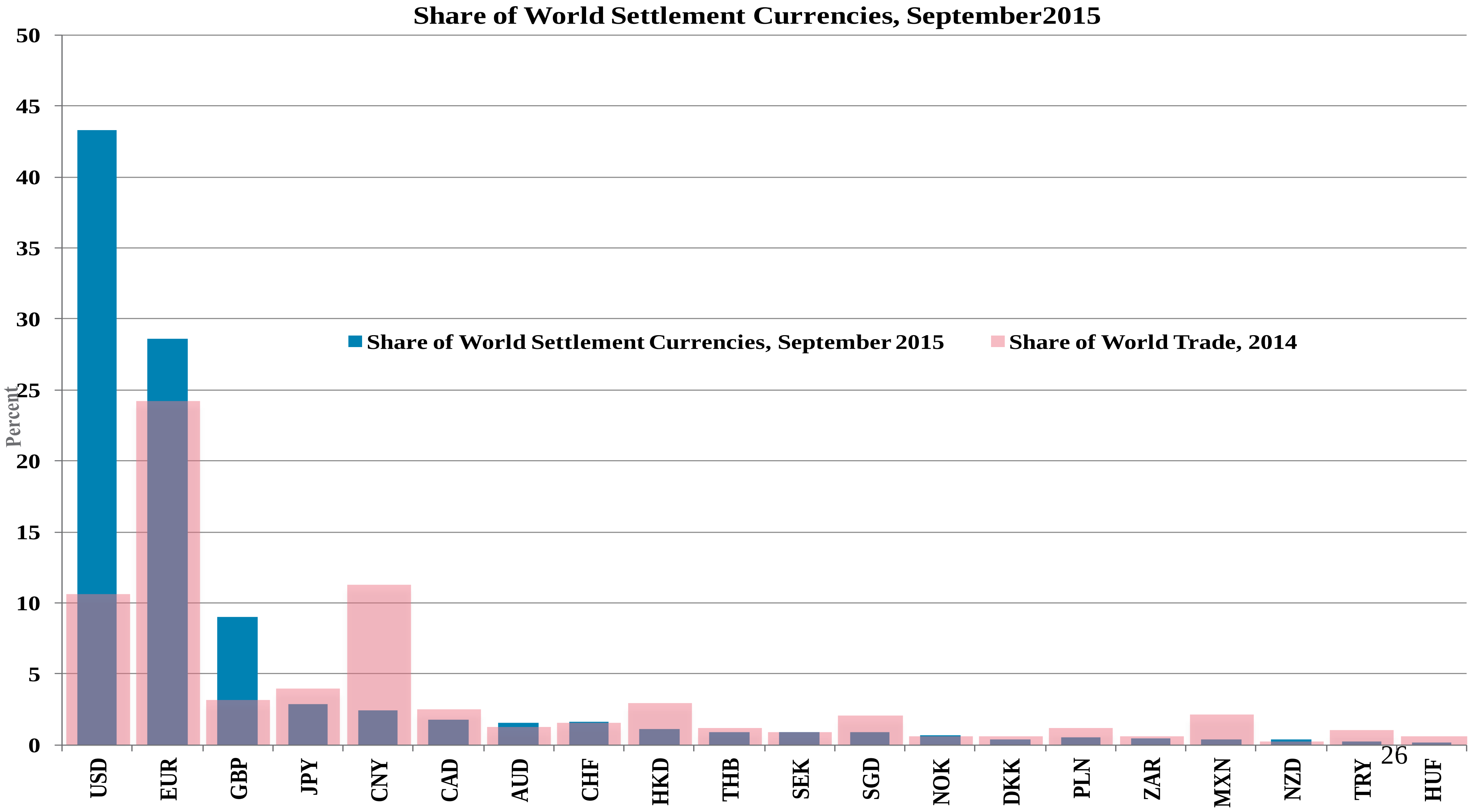


The Rates of Growth of Chinese Quarterly Real GDP and the Shanghai Stock Index (1993-)

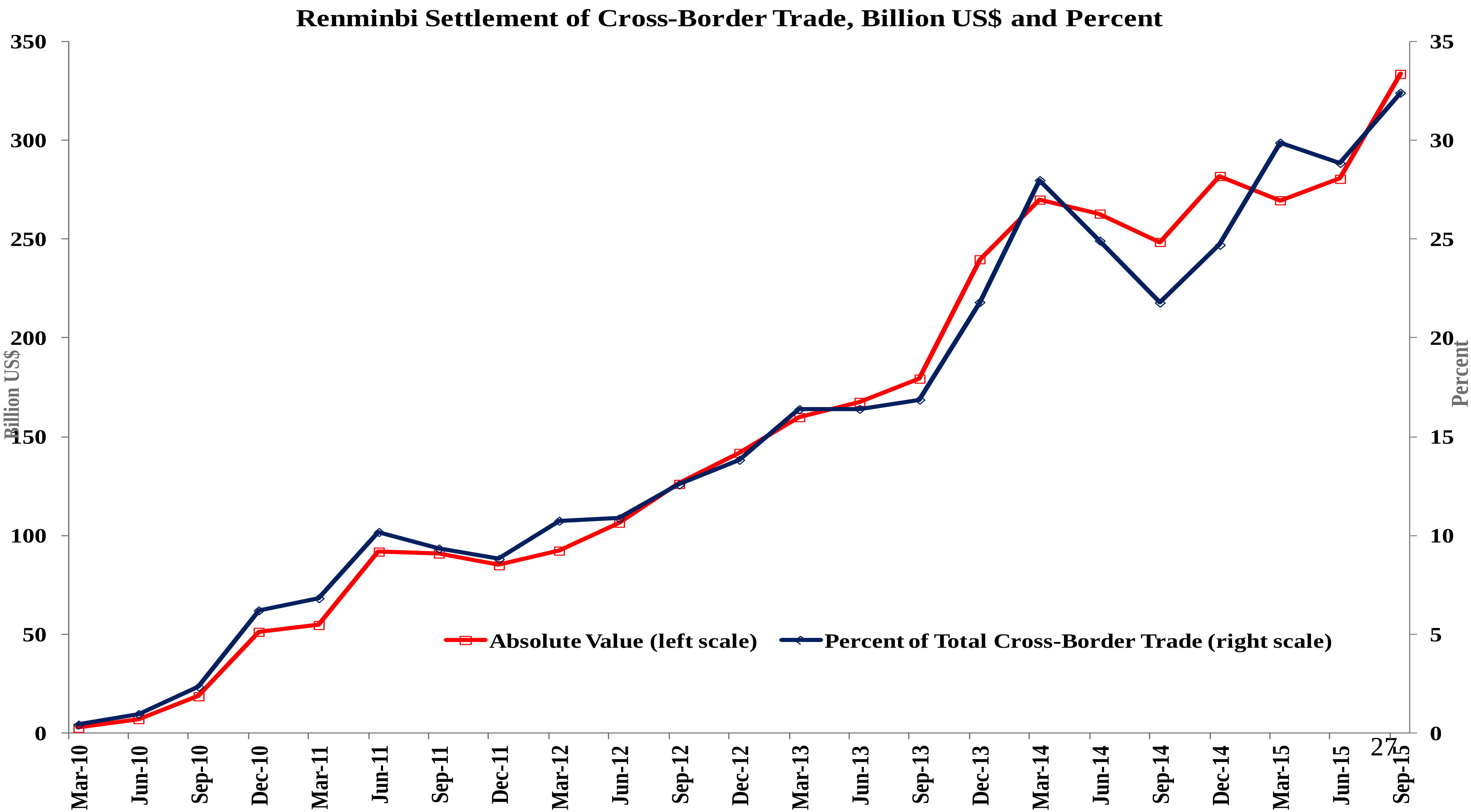
The Internationalization of the Renminbi

- The Renminbi, the Chinese currency, is increasingly used as an invoicing and settlement currency for cross-border transactions, especially those involving Chinese enterprises as transacting parties.
- The proportion of Mainland Chinese international trade settled in Renminbi has grown rapidly, from almost nothing in 2010Q1 to 32.4% of the total value of Chinese international trade in goods in 2015Q3 (US$333.5 billion). In absolute value, more than a US$1.33 trillion worth of Chinese international trade is now settled in Renminbi annually.

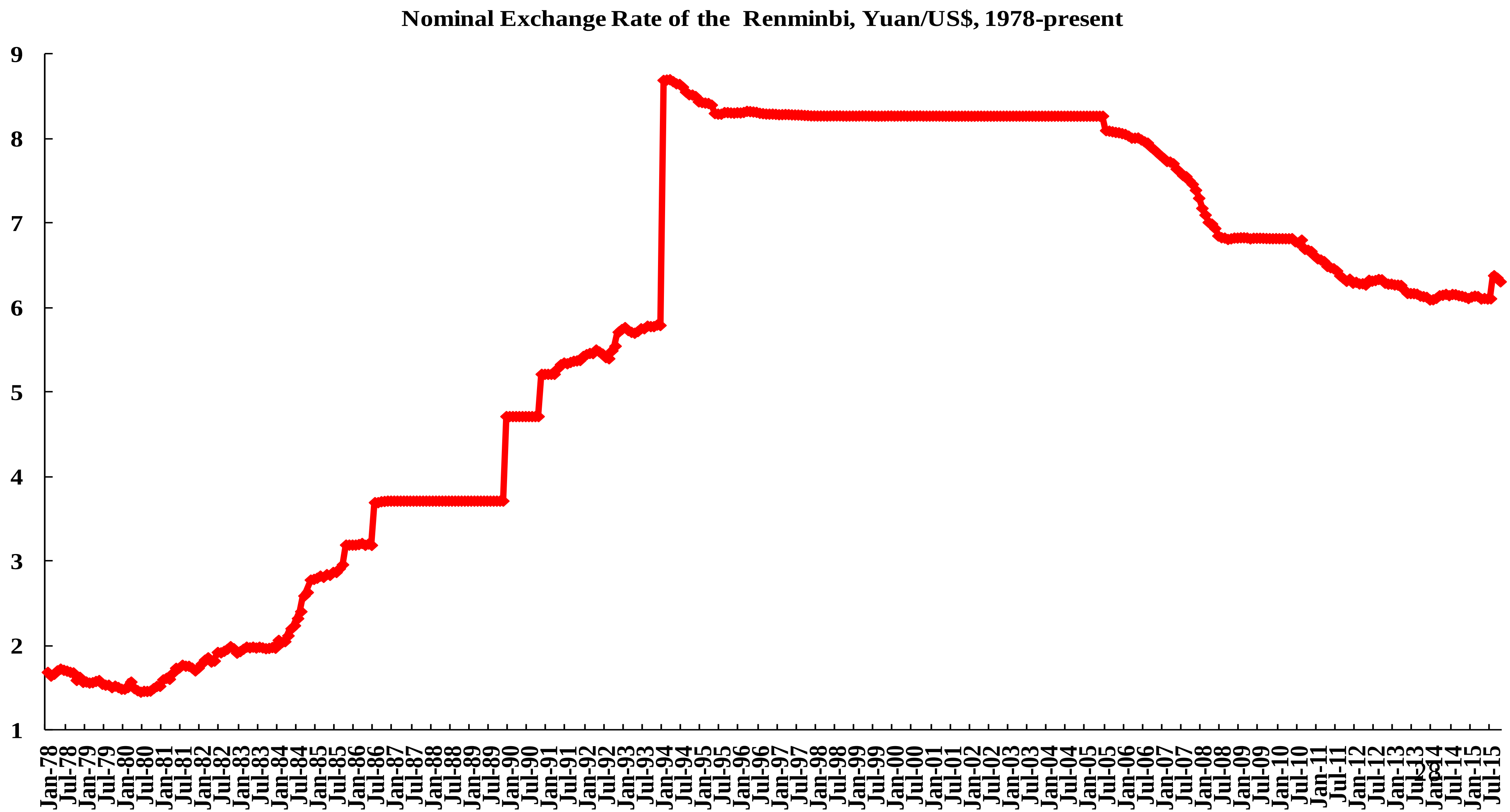
Distribution of World Trade Settlement Currencies versus World Trade, Sept. 2015



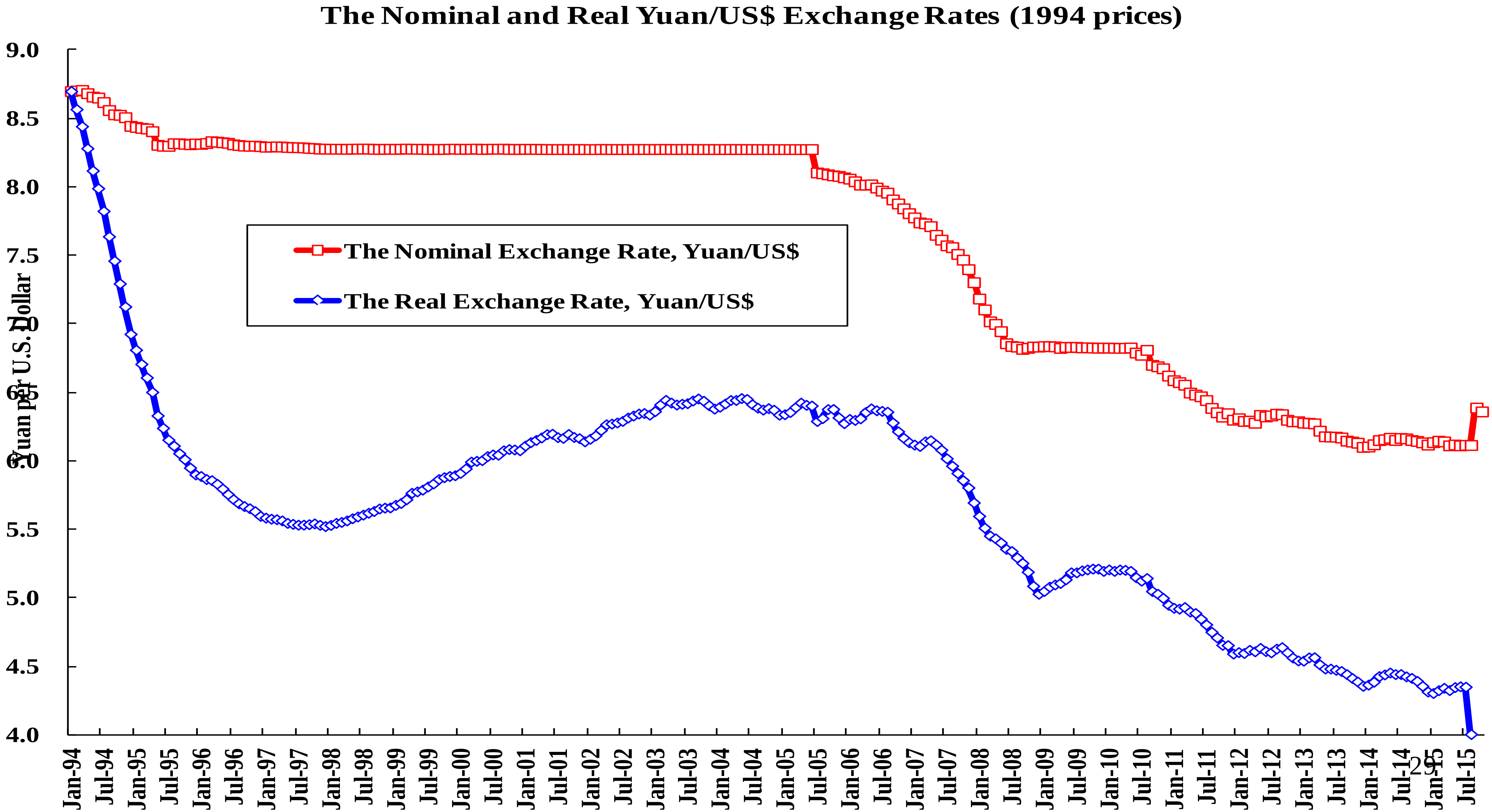
Renminbi Settlement of Chinese Cross-Border Trade, Billion US$ and Percent



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



The Nominal and Real Yuan/US$ Exchange Rates



The Internationalization of the Renminbi

- The Renminbi exchange rate is likely to hold steady vis-a-vis the US$ in the near term.
- It is in China's interests to promote the use of its own currency, the Renminbi, as a medium of international exchange, certainly in international transactions in which its national is one of the transacting parties. This requires a stable exchange rate vis-a-vis the US$.
- China will continue to face a net capital outflow, which is natural and expected as its enterprises (and in time its households) diversify their investment to overseas. However, this does not diminish its ability to stabilize the Renminbi exchange rate. It has large foreign exchange reserves of US$3.6 trillion. It still runs a significant trade surplus amounting to 2% of its GDP.
- China will over time become a large net capital exporter, especially as its enterprises and households attempt to re-balance its portfolio if and when capital controls are fully lifted. There will be a significant one-time stock adjustment when capital control is finally completely lifted.

The Internationalization of the Renminbi

- A devaluation is unlikely to be helpful to the Chinese economy. China does not want to return to making garments, shoes and stuffed toys with the lower standard of living that it implies. The Chinese economy has also become too large to be sustained by exports alone.
- It is also not in the best interests for China to compete with the other East Asian developing economies. China should be moving up the value chain, as Japan, Hong Kong, South Korea and Taiwan did before.
- The U.S. accepts the status quo, that is, a Renminbi that is informally pegged to the US$. (This may not be the preference of U.S. hedge funds that have been hoping for a Renminbi devaluation.)

Concluding Remarks

- In the near to medium term, continuing Chinese economic growth going forward will depend mostly on the growth of internal demand (public 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.
- The growth in household consumption will do its part, especially in the demand for services. The expanding and rising middle class will play a crucial role.
- In the longer run, Chinese economic growth will make a transition from tangible-inputs-driven to intangible-inputs- or innovation-driven.
- 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 annual real rate of growth of around 6.5%.