

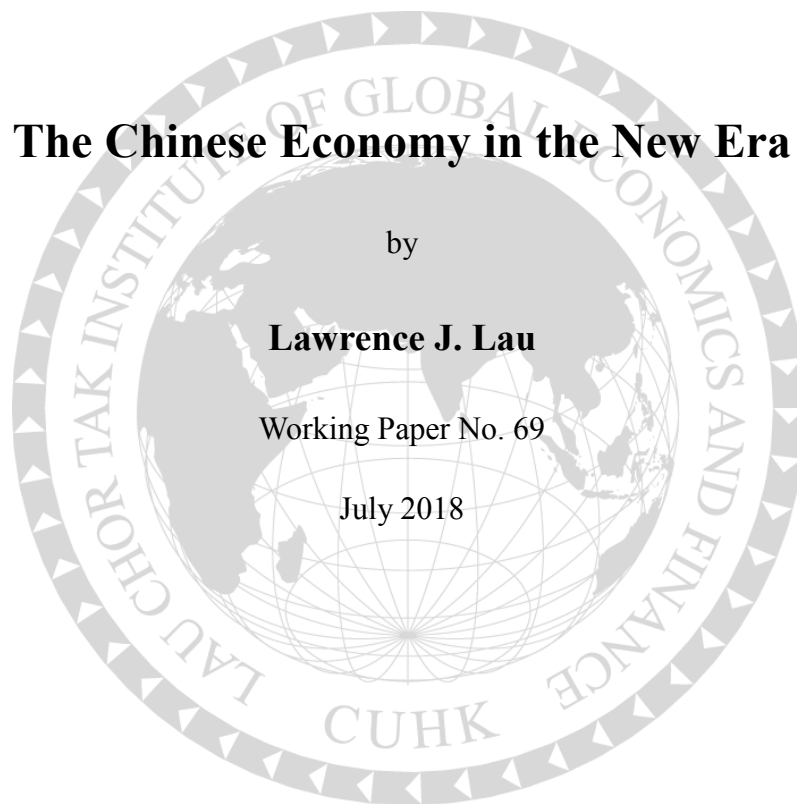
# **The Chinese Economy in the New Era**

by

**Lawrence J. Lau**

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# The Chinese Economy in the New Era<sup>§</sup>

Lawrence J. Lau<sup>1</sup>

July 2018

**Abstract:** The “New Era,” a term introduced by President Xi Jinping, may also be identified as the Xi Era, during which China will be transformed from a moderately well-off to a strong and wealthy nation. In the new era, the Chinese Government will undertake to deepen economic reform, widen economic opening, and enhance the quality of economic growth. It is also expected to ensure shared prosperity for all and reduce systemic risks to the economy. Our projections show that by 2020, Chinese real GDP per capita, in 2017 prices, will exceed US\$10,000, an economic development milestone. By 2031, Chinese real GDP will surpass U.S. real GDP (US\$29.4 trillion versus US\$29.3 trillion), making China the largest economy in the world. However, Chinese real GDP per capita will still lag behind the U.S. significantly, amounting to only one-quarter of that of the U.S. By 2050, Chinese real GDP will reach US\$82.6 trillion, compared to US\$51.4 trillion for the U.S. However, in terms of real GDP per capita, China will still lag significantly behind, at US\$53,000, slightly less than the current level of U.S real GDP per capita, compared to US\$134,000 for the U.S.

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<sup>1</sup> The author is Ralph and Claire Landau Professor of Economics, The Chinese University of Hong Kong, and Kwoh-Ting Li Professor in Economic Development, Emeritus, Stanford University. He wishes to thank Professor Albert E. Dien, Mrs. Ayesha Macpherson Lau, and Professor Yanyan Xiong for their insightful comments and suggestions and Mr. Junjie Tang and Mr. Ting Hin Yan for their able research assistance. He retains sole responsibility for all remaining errors. The opinions expressed herein are those of the authors and do not necessarily reflect the views of the Institute.

## 1. Introduction

### The New Era

What is the meaning of the “New Era”? The New Era refers specifically to present-day China. Three distinct eras may be distinguished in the history of the People’s Republic of China since its establishment in 1949:

(1) 1949–1978, the Mao Zedong Era—during which the People’s Republic of China was established and consolidated;

(2) 1979–2012, the Deng Xiaoping Era<sup>2</sup>—during which economic reform was undertaken, and the Chinese economy was opened to the world; and

(3) 2013–, the Xi Jinping Era—during which China was transformed from a moderately well-off to a modernised, strong, and wealthy nation.

Today, China is already the second largest economy in the world. At its current average annual rate of growth of approximately 6%, it is expected to catch up with and overtake the U.S. to become the world’s largest economy some time before 2035. Nevertheless, even then, Chinese real GDP per capita, at a projected US\$20,000 in 2017 prices, will still be less than one-quarter of the projected then U.S. real GDP per capita.

In the new era, the principal driving force of the economy is the contradiction between “unbalanced and inadequate development” of the economy and “the people’s ever-growing need for a better life”. The economic tasks in the new era are aimed at enabling the economy to better serve the people’s needs. Thus, the Chinese Government will undertake to deepen reform, widen opening, and enhance quality. It is also expected to share prosperity and reduce risks to the economy. The Deng Era was one in which some of the people would become wealthy first. In the Xi Era, all people will become wealthy together. In the Thirteenth Five-Year (2016–2020) Plan, the only mandatory targets have to do with the preservation, protection, and restoration of the environment and the alleviation and elimination of poverty. In the Xi Era, the economic policies will be people-centric. A modern socialist market

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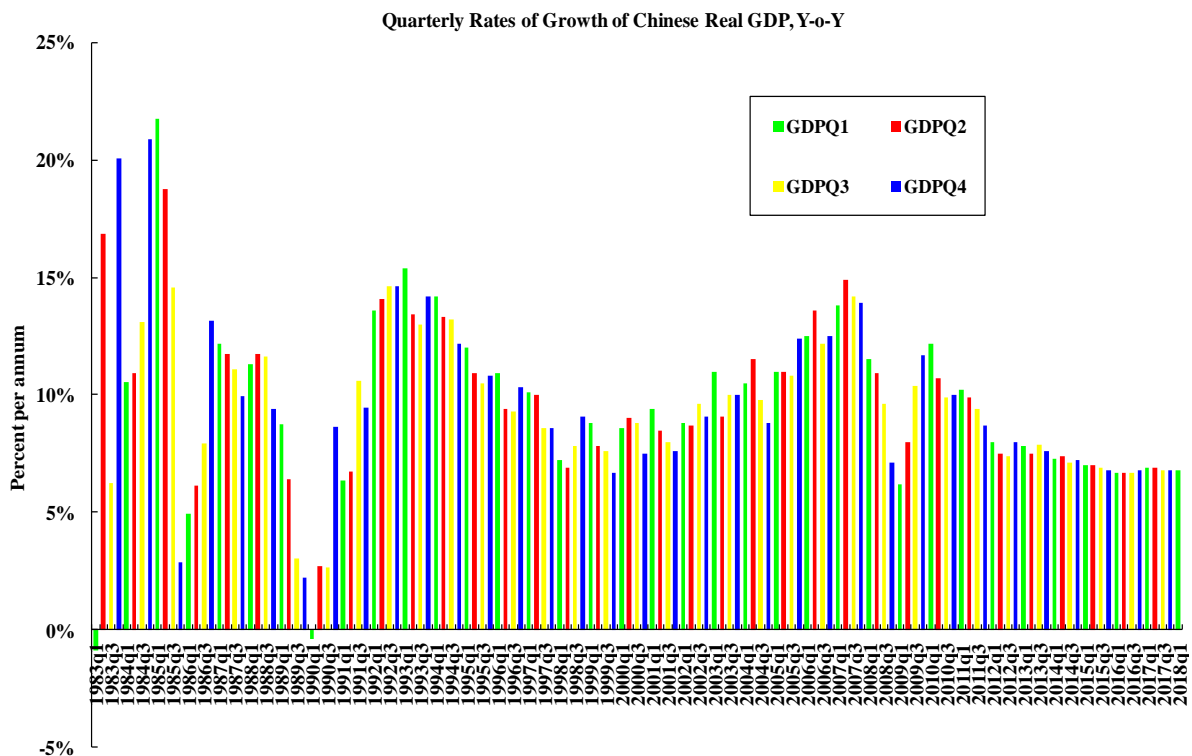
<sup>2</sup> While Mr. Deng Xiaoping passed away in 1997, this era can still be referred to as the Deng Era because his policies of reform and opening were continued, and the two senior leaders that followed Mr. Deng, Mr. Jiang Zemin and Mr. Hu Jintao, were both chosen by him.

economy with Chinese characteristics will be established under the leadership and stewardship of the Communist Party of China.

## The Chinese Economy in 2017

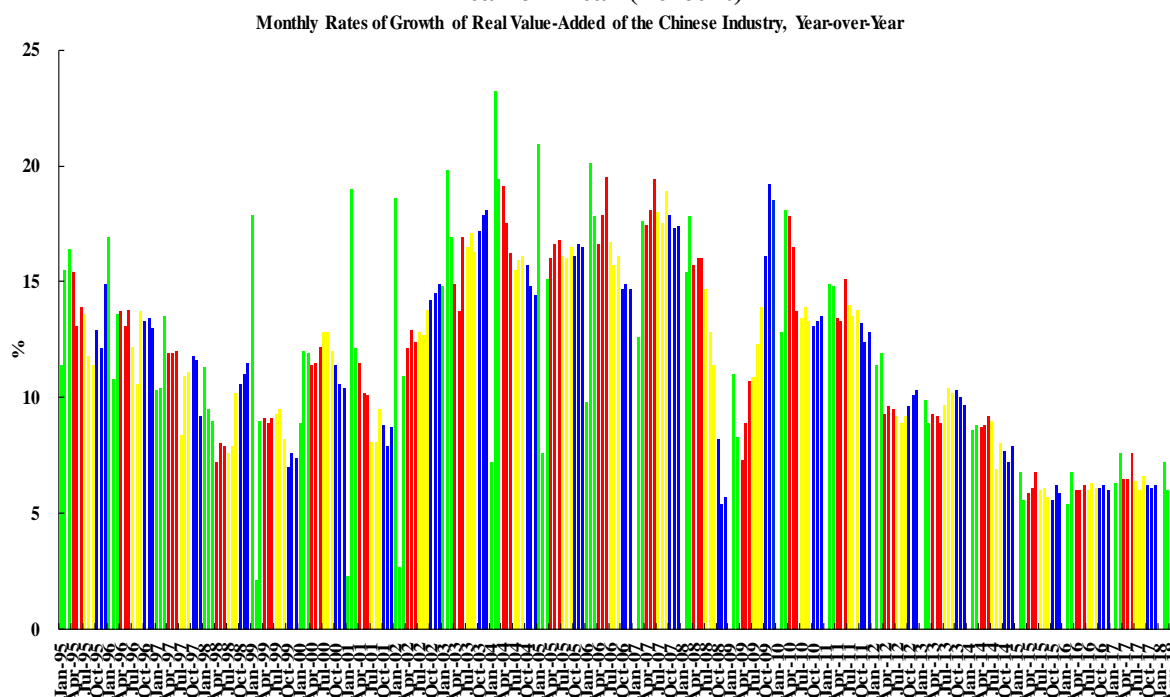
We begin with a brief review of the Chinese economy in 2017. The rate of growth of real GDP was 6.9%, its first year-on-year increase since 2011 (see Chart 1). (The rate of growth of real GDP in the first quarter of 2018 was 6.8%.) This signals the end of the vertical portion and the beginning of the horizontal portion of the “L-shaped” recovery. The monthly rates of growth of the real value added of the Chinese industrial sector also confirm that the rates of growth of the economy have stabilised and are no longer declining (see Chart 2). The rate of growth of the consumer price index (CPI) was 1.6% compared to 2% in 2016. In contrast, the producer price index (PPI) increased by 6.3%, the first increase in years, indicating that the reduction of excess production capacities had begun to have some success.

**Chart 1: Quarterly Rates of Growth of Chinese Real GDP, Year-on-Year (Percent)**



Source: National Bureau of Statistics of China (<http://data.stats.gov.cn/easyquery.htm?cn=B01>)

**Chart 2: The Monthly Rates of Growth of Real Value Added of Chinese Industry, Year-on-Year (Percent)**



Source: National Bureau of Statistics of China (<http://data.stats.gov.cn/easyquery.htm?cn=A01>)  
[http://www.stats.gov.cn/tjsj/zxfb/201806/t20180614\\_1604530.html](http://www.stats.gov.cn/tjsj/zxfb/201806/t20180614_1604530.html)

In 2017, employment increased by more than 13 million. The urban unemployment rate at year end was 4.98%. The disposable income per capita increased by 7.3%, more than the growth of real GDP and real GDP per capita. The Renminbi exchange rate remained stable. The level of official foreign exchange reserves was little changed, amounting to US\$3.14 trillion at year-end 2017, equivalent to almost one and a half year worth of annual imports (US\$2.21 trillion in 2017). The energy consumed per unit of real GDP declined by 3.7%, indicating an improvement in the quality of growth. The capacity utilisation rate in industry rose to 77%, reflecting the progress in the supply-side structural reform and the reduction of excess production capacities.

## **2. Deepening Economic Reform**

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

## **3. Widening Economic Opening to the World**

China has been a major beneficiary of economic globalisation. At least 600 million Chinese people have been lifted up from poverty through Chinese economic reform and opening up since 1978 (see the discussion in Section 5 below). A study of Chinese history indicated that the closing of the borders in the Ming and Qing Dynasties (and also in the early years of the People’s Republic of China) was in retrospect a huge mistake. China failed to take advantage of its then comparative advantages. (Of course, the forced imports of opium by Great Britain in the 19th century was another issue.) Japan’s opening to the world since the Meiji Restoration of 1868 enabled its rapid development into a modern nation. China was left far behind. Isolationism and protectionism have repeatedly proved to be failed ideas.

Today, forty years after the beginning of economic reform and opening up, China is already the most important trading partner of many countries and regions (see Table 1). However, Chinese exports are only a relatively small percentage, less than 15 percent, of Chinese GDP, similar to other large economies such as the U.S., Japan, and India (see Chart

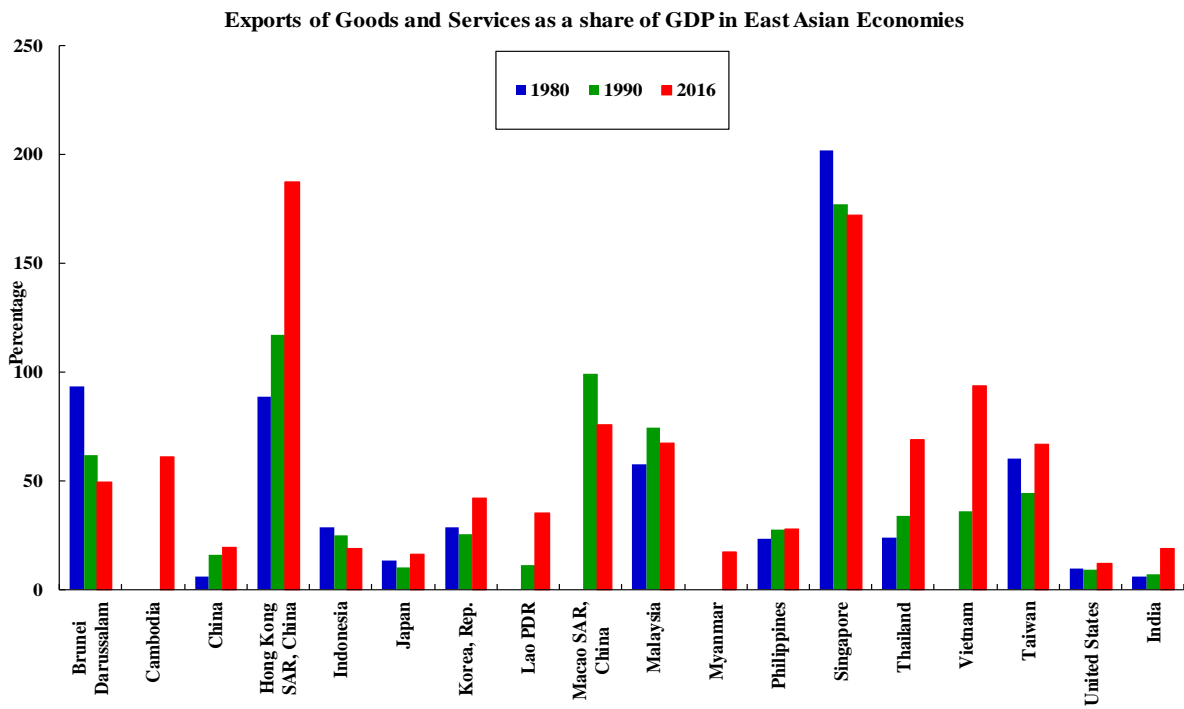
3). What this means is that while Chinese exports and imports may experience large fluctuations as in many other economies, its GDP remains relatively stable, in contrast to the other smaller economies (see Charts 4–6). In other words, the Chinese economy today is not too vulnerable to external disturbances, including those possibly caused by a trade war.

**Table 1: The Ranks of China as a Trading Partner of Asia-Pacific Countries/Regions and Vice Versa, 2017**

<b>Country/Region</b>	<b>China Rank as Trading Partner of Country/Region</b>	<b>Rank of Country/Region as Trading Partner of China</b>
<b>Australia</b>	<b>1</b>	<b>7</b>
<b>Brunei</b>	<b>4</b>	<b>125</b>
<b>Cambodia</b>	<b>1</b>	<b>63</b>
<b>Hong Kong</b>	<b>1</b>	<b>3</b>
<b>Indonesia</b>	<b>1</b>	<b>17</b>
<b>Japan</b>	<b>1</b>	<b>2</b>
<b>Korea</b>	<b>1</b>	<b>4</b>
<b>Laos</b>	<b>2</b>	<b>85</b>
<b>Macau</b>	<b>1</b>	<b>81</b>
<b>Malaysia</b>	<b>1</b>	<b>9</b>
<b>Myanmar</b>	<b>1</b>	<b>44</b>
<b>New Zealand</b>	<b>1</b>	<b>41</b>
<b>Philippines</b>	<b>1</b>	<b>20</b>
<b>Singapore</b>	<b>1</b>	<b>14</b>
<b>Taiwan</b>	<b>1</b>	<b>5</b>
<b>Thailand</b>	<b>1</b>	<b>13</b>
<b>United Kingdom</b>	<b>3</b>	<b>15</b>
<b>United States</b>	<b>1</b>	<b>1</b>
<b>Vietnam</b>	<b>1</b>	<b>8</b>

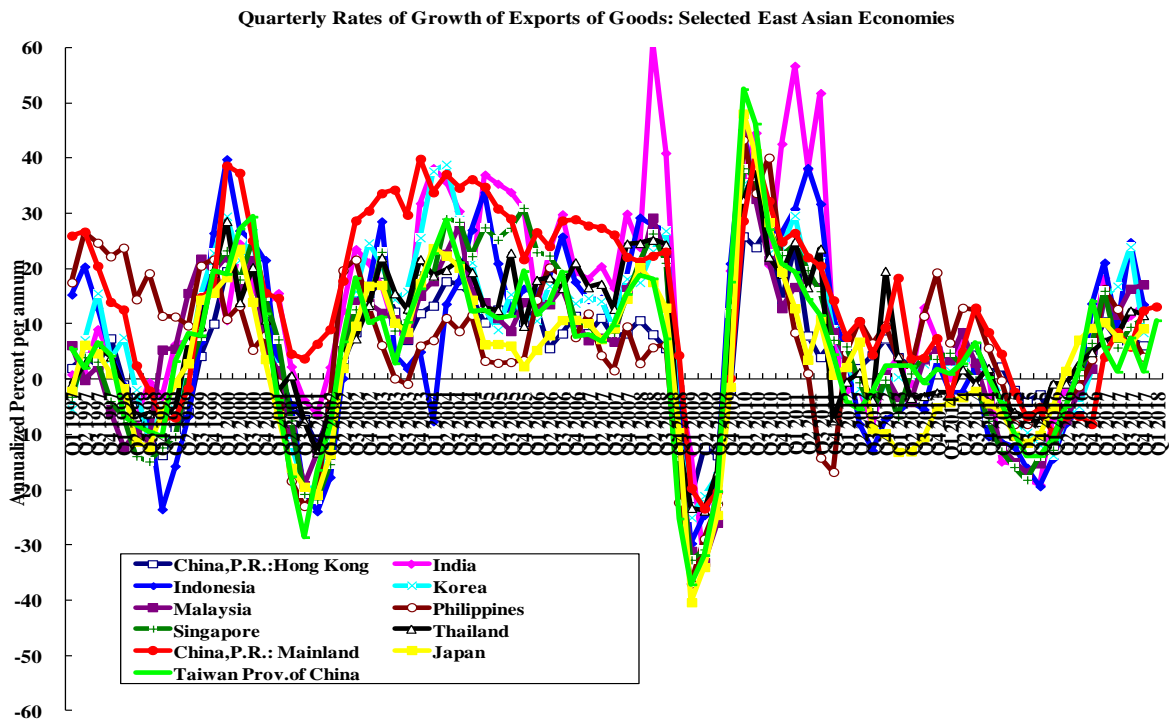


**Chart 3: Exports of Goods and Services as a Share of GDP in Selected Economies**



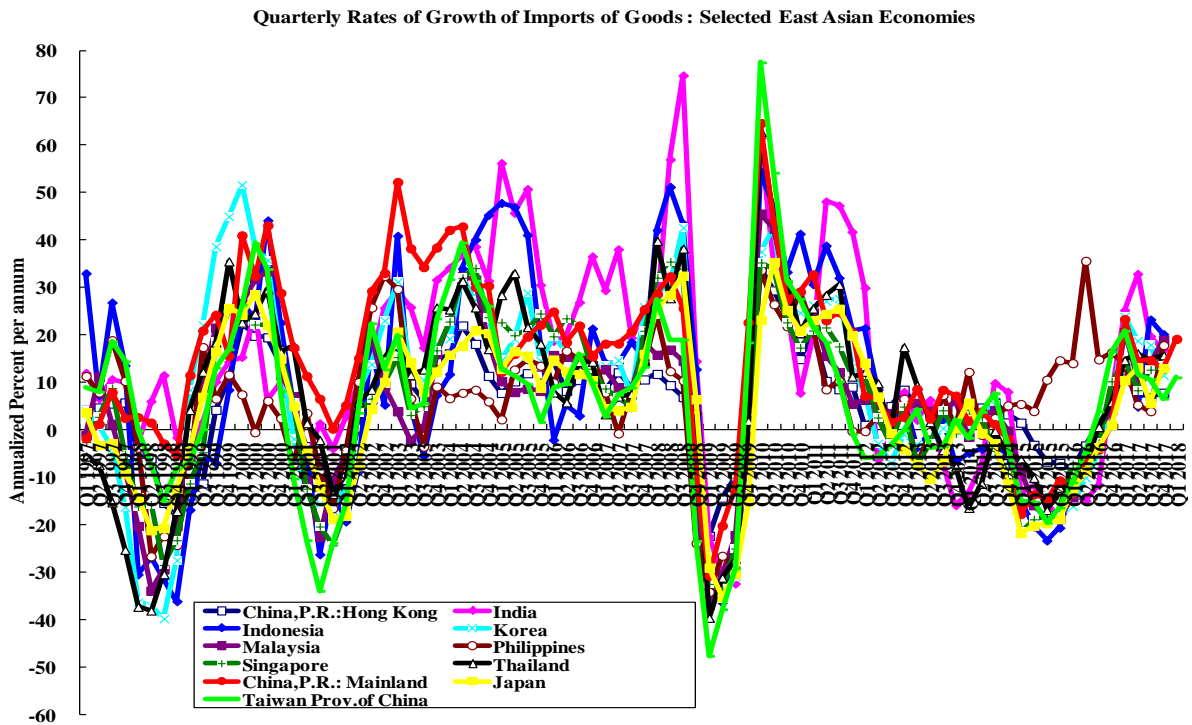
Sources: World Development Indicators, The World Bank; data for Taiwan, China are from <https://eng.stat.gov.tw/mp.asp?mp=5>.

**Chart 4: Quarterly Rates of Growth of Exports of Goods: Selected Asian Economies**



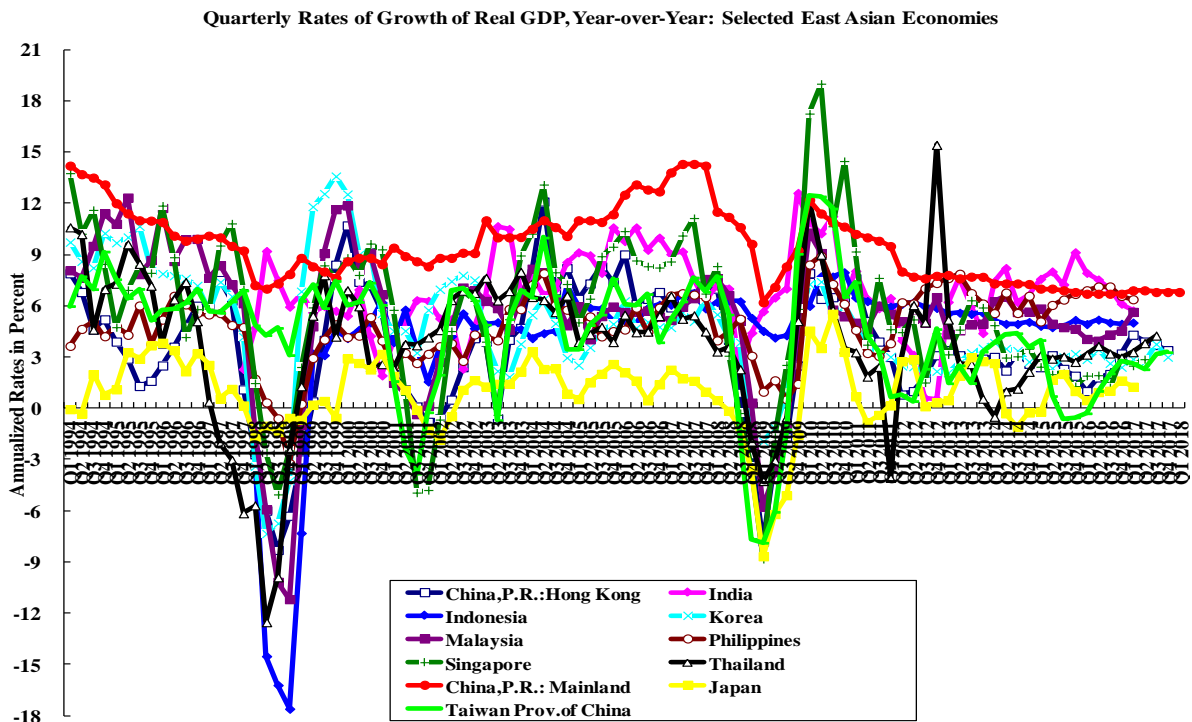
Sources: International Financial Statistics, International Monetary Fund; data for Taiwan, China are from <https://eng.stat.gov.tw/mp.asp?mp=5>.

**Chart 5: Quarterly Rates of Growth of Imports of Goods: Selected Asian Economies**



Sources: International Financial Statistics, International Monetary Fund; data for Taiwan, China are from <https://eng.stat.gov.tw/mp.asp?mp=5>.

**Chart 6: Quarterly Rates of Growth of Real GDP, Year-on-Year: Selected Asian Economies**



Sources: International Financial Statistics, International Monetary Fund; data for Taiwan, China are from <https://eng.stat.gov.tw/mp.asp?mp=5>.

Opening its economy wider serves Chinese interests. With a national savings rate exceeding 40 percent, China continues to have substantial excess national savings. China wishes to continue to benefit from technology transfer, which has begun to be more two-way. Competition from foreign firms can exert pressure on Chinese enterprises in Chinese markets and help to prevent the emergence of monopolies and quasi-monopolies, thus making Chinese enterprises more efficient, more quality-conscious, and more competitive. However, China, like all other large economies, can readily survive on its own if necessary. The experience since the Global Financial Crisis of 2007–2008 clearly demonstrated that this was indeed the case (see Charts 4–6).

The Chinese Government has already announced that it will expand imports and reduce tariffs (e.g., on automobiles). Customs revenue is already a very small percentage of the total revenue of the central government (260 billion Yuan compared to 16 trillion Yuan, or 1.6%, in 2016), so loss of revenue is not an important consideration. Many Chinese manufacturing enterprises are already among the largest in the world. They are no longer “infants” that need protection from imports. China aims to balance its international trade in goods and services and not to maintain a surplus. China will also continue to liberalise the rules for foreign direct investment into China and improve the investment environment, including allowing majority and wholly owned foreign enterprises in both financial and manufacturing sectors (e.g., insurance, securities brokerage, and automobile manufacturing). This will make the complaints about “forced technology transfer” moot as foreign direct investors no longer need to take local partners if they do not find it advantageous to do so. China has in the last few years already greatly improved the protection of intellectual property through its establishment of special intellectual property courts that have nationwide jurisdiction. These efforts will continue as China has also become an inventive nation itself and has an interest in protecting intellectual property and facilitating innovation.

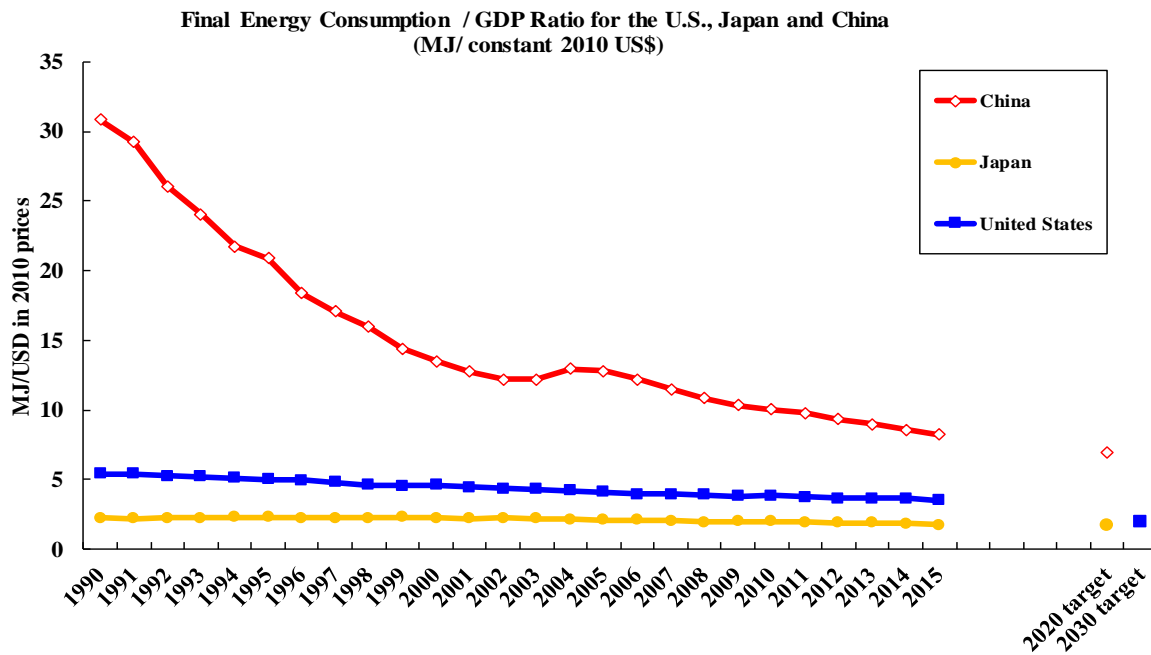
#### **4. Enhancing the Quality of Growth**

The focus of the Chinese economy going forward will be on the quality of growth rather than the quantity of growth. It means growth with an emphasis on environmental protection and preservation, and the restoration of green mountains, blue skies, and clear waters in China. It also means growth that is innovation-driven rather than input-driven. It means more competitive markets through the regulation of monopolies and quasi-monopolies and the use of anti-trust laws. It means growth with an emphasis on product safety, especially in food and drugs. It also means growth with a more equitable distribution (and redistribution) of income, through the alleviation and eradication of poverty, the provision of public goods (including, in addition to the environment, education, health care, and elderly care), and reform of the wage determination mechanism. The problem of the status of long-term migrant workers in urban areas will also have a permanent solution through the revision of household registration rules.

##### **Increasing Energy Efficiency**

One measure of energy efficiency is the energy used per unit real GDP. In Chart 7, we compare the energy-GDP ratios of China, Japan, and the United States in terms of million joules per unit real GDP in 2010 U.S. dollars. (The joule is a unit of energy and is equal to the more familiar 0.000948 BTU (British thermal unit)). It is clear that China has been improving its energy efficiency over time, which implies that overall carbon emission per unit real GDP is being steadily reduced. However, China still has significant room to improve, compared to Japan and the U.S. By 2020, the Chinese economy will still use more energy per unit GDP than both the U.S. and Japan (although part of this is due to the higher shares of the service sector, which uses much less energy, in the GDPs of Japan and the U.S.). However, China is committed to an absolute reduction of its carbon emissions around 2030 in accordance with the 2016 Paris Climate Agreement and should continue to make progress beyond 2020.

**Chart 7: Final Energy Consumption/GDP Ratio for China, Japan, and the U.S.  
(Million Joules/2010 US\$)**

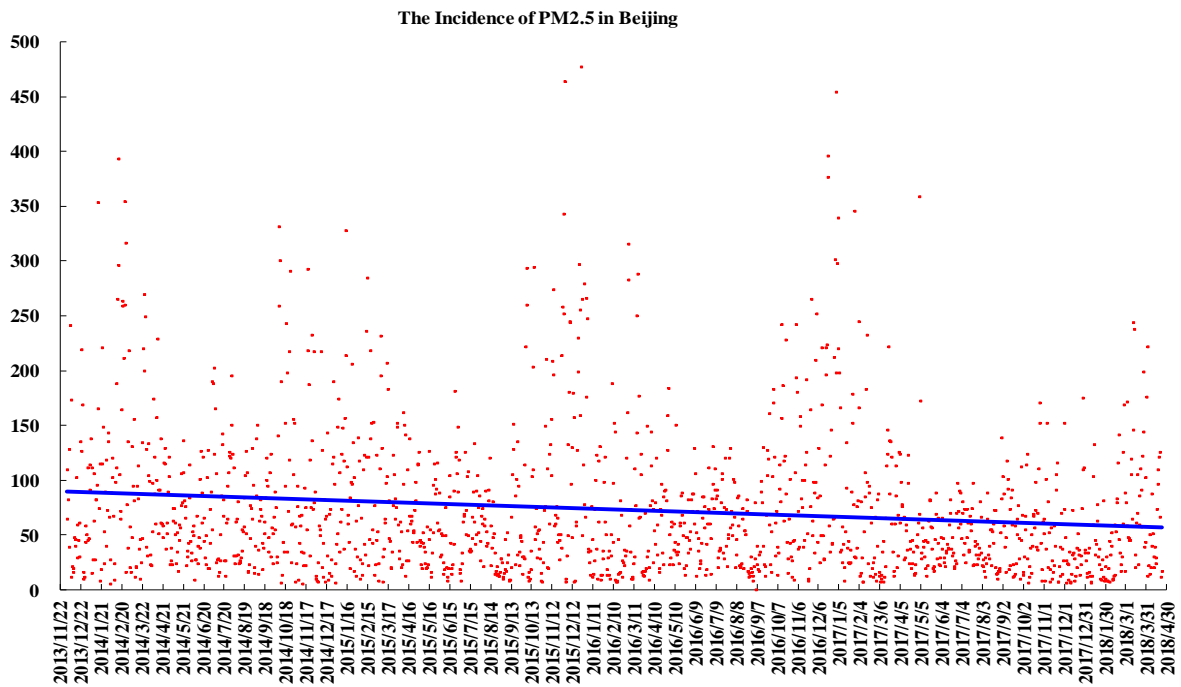


Sources:

1. Total final energy consumption (trillion joules):  
[http://databank.worldbank.org/data/reports.aspx?source=1261&series=1.1\\_TOTAL.FINAL.ENERGY.CONSUM#](http://databank.worldbank.org/data/reports.aspx?source=1261&series=1.1_TOTAL.FINAL.ENERGY.CONSUM#)
2. GDP (constant 2010 US\$):  
<http://databank.worldbank.org/data/reports.aspx?source=1277&series=EG.USE.COMM.KT.OE#>
3. China 2020 target: [http://www.gov.cn/zhengce/content/2016-11/04/content\\_5128619.htm](http://www.gov.cn/zhengce/content/2016-11/04/content_5128619.htm)
4. Japan 2020 target: <https://eneken.ieej.or.jp/en/data/pdf/175.pdf>
5. United States 2030 target:  
<https://www.iea.org/publications/freepublications/publication/EnergyEfficiencyTargetsEnergyEfficiencyInsightsBrief.pdf> Reduction of Pollution

Another measure of the quality of economic growth is the quantity of PM2.5 particles in the air of major urban centres. In Chart 8, we present the incidence of PM2.5 particles in Beijing between 2013 and 2018. Here we can see from the data the gradual improvement in the air quality in Beijing. It still has a considerable way to go. However, as the quality of air has become a mandatory key performance indicator in the Thirteenth Five-Year Plan, it will likely continue to improve over time, not only in Beijing, but in all major urban centres in China.

**Chart 8: The Incidence of PM2.5 in Beijing: Daily Data from 2013M2 to 2018M4**

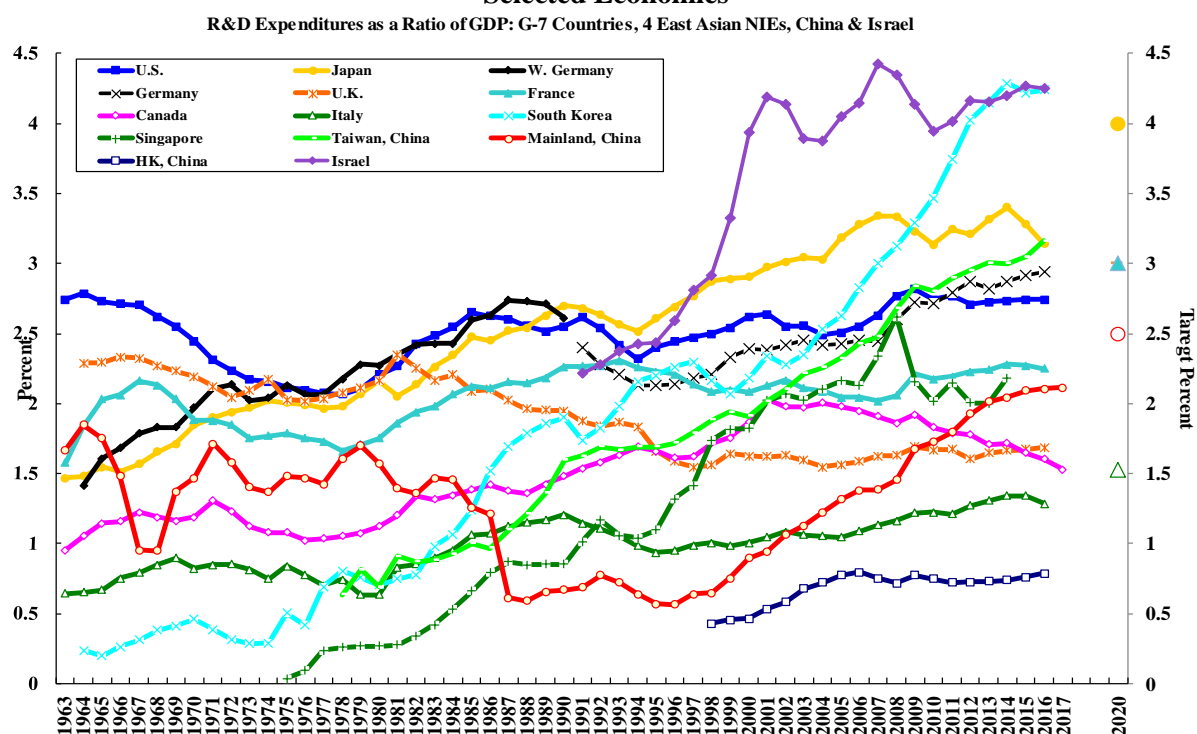


Source: PM2.5 (<https://www.aqistudy.cn/historydata/monthdata.php?city=%E5%8C%97%E4%BA%AC.>)

### **Promoting Innovation**

Investment in intangible capital (human capital and research and development (R&D) capital) is indispensable for innovation. The annual expenditures on R&D as percentages of GDP are presented for selected economies in Chart 9. Chart 9 shows that the U.S. has consistently invested a relatively high percentage of its GDP in R&D, averaging 2.5% since 1963. Even though the East Asian economies, including China, have lagged behind, they have been catching up fast, with the exception of Hong Kong. China is expected to reach its R&D expenditure target of 2.5% of GDP in 2020, approximately the same as the average U.S. share in the past. However, it will still be below the expected or targeted levels of the European countries, Japan, and South Korea.

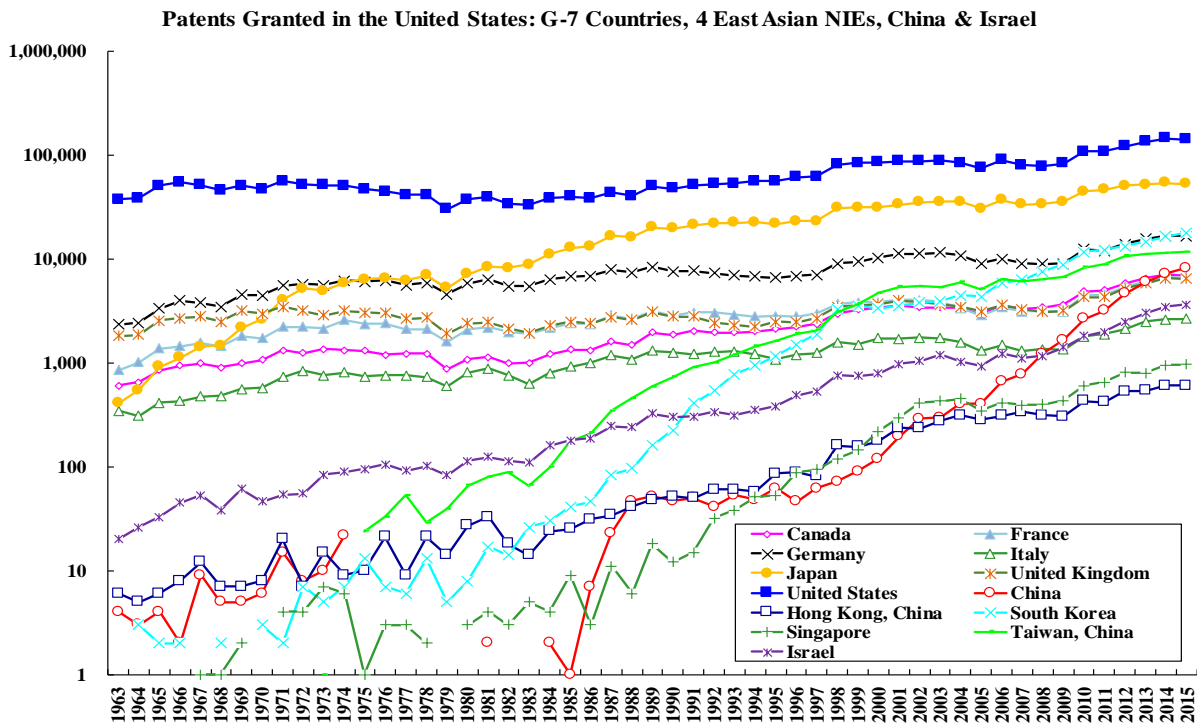
**Chart 9: R&D Expenditures as a Share of GDP and Their Target Levels for 2020:  
Selected Economies**



Source: Lawrence J. Lau and Yanyan Xiong (2018), “Are There Laws of Innovation,” Working Paper, Lau Chor Tak Institute of Global Economics and Finance, The Chinese University of Hong Kong.

One indicator of the potential for innovation is the number of patents granted each year. In Chart 10, the number of patents granted in the United States each year to the nationals of different countries, including the U.S. itself, over time is presented. The U.S. is the undisputed champion over the past forty years, with 140,969 patents granted in 2015, followed by Japan, with 52,409. (Since these are patents granted in the U.S., the U.S. may have a home advantage; however, for all the other countries and regions, the comparison across them should be fair.) The number of patents granted to Chinese applicants each year has increased from single-digit levels prior to the mid-1980s to 8,166 in 2015. The economies of South Korea and Taiwan, granted 17,924 and 11,690 U.S. patents respectively in 2015, were far ahead of Mainland China.

**Chart 10: Patents Granted in the United States: Selected Economies**

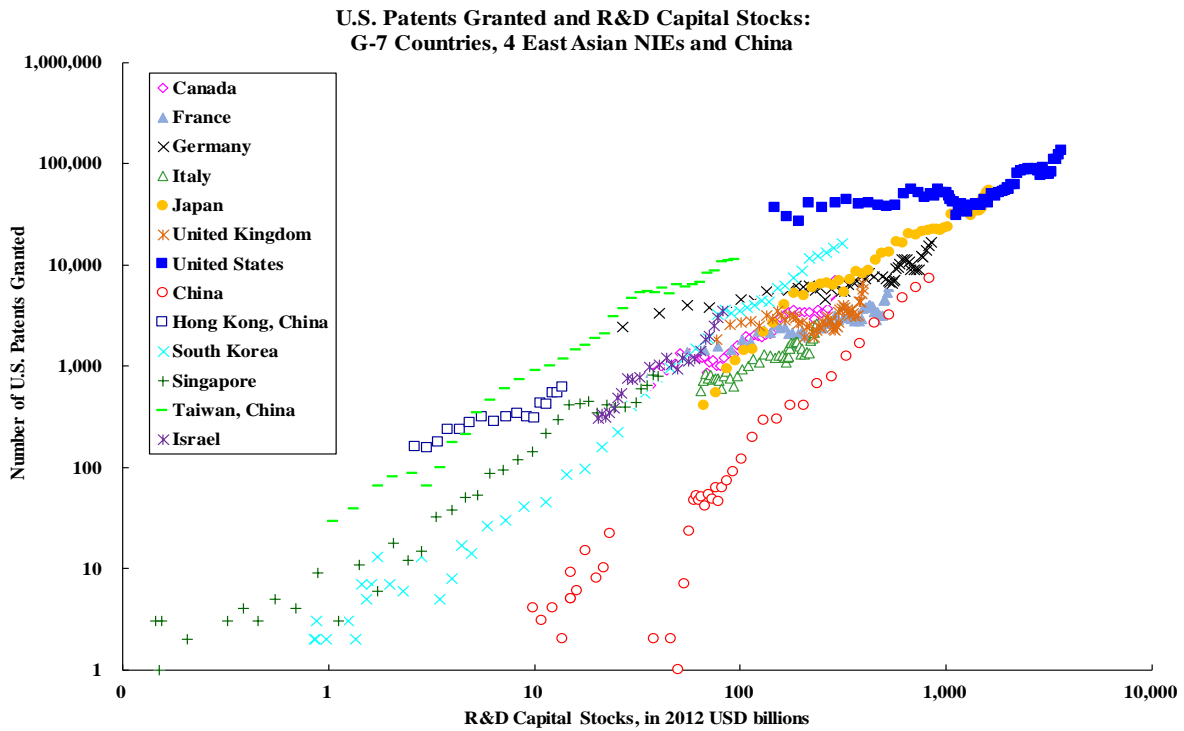


Source: Lawrence J. Lau and Yanyan Xiong (2018), “Are There Laws of Innovation,” Working Paper, Lau Chor Tak Institute of Global Economics and Finance, The Chinese University of Hong Kong.

The R&D capital stock, defined as the cumulative past real expenditures on R&D less depreciation of 10% per year, is a useful indicator of innovative capacity. R&D expenditure should quite properly be treated as investment since R&D efforts generally take years to yield any positive results. The R&D capital stock can be shown to have a direct and positive causal relationship with the number of patents granted (see Chart 11, in which the annual number of U.S. patents granted is plotted against the R&D capital stock of that year for each selected economy). Chart 11 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.



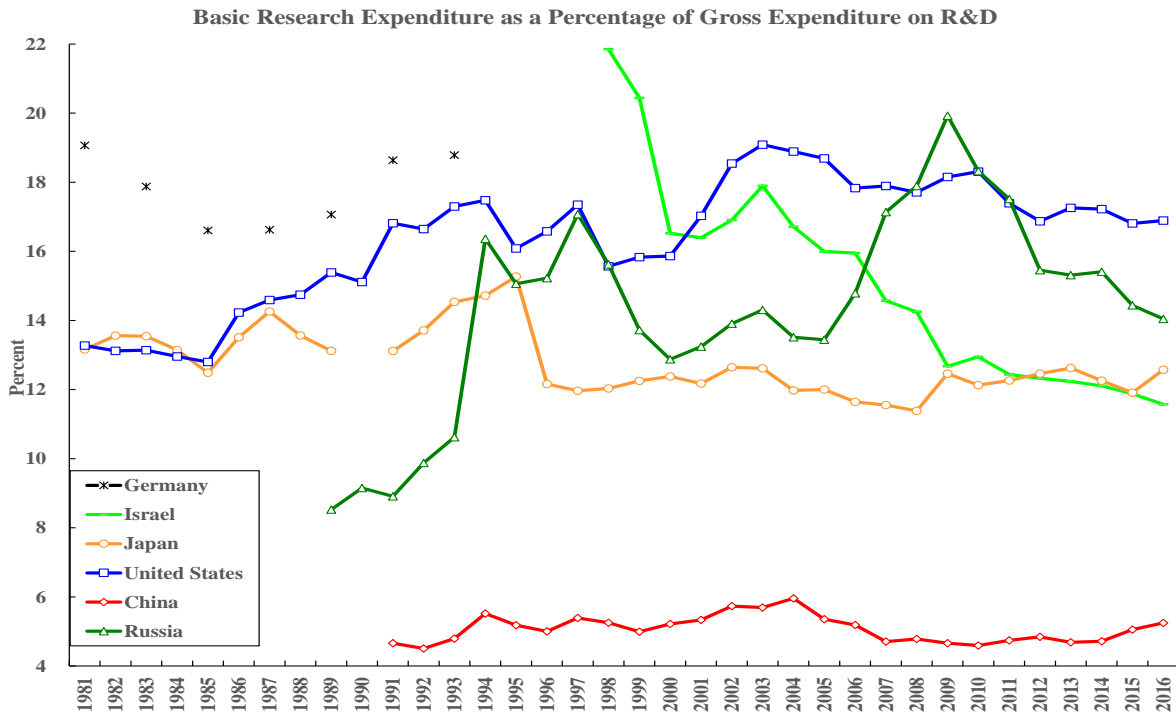
**Chart 11: U.S. Patents Granted and R&D Capital Stocks: Selected Economies**



Source: Lawrence J. Lau and Yanyan Xiong (2018), “Are There Laws of Innovation,” Working Paper, Lau Chor Tak Institute of Global Economics and Finance, The Chinese University of Hong Kong.

However, in order for breakthrough discoveries or inventions to be made, there must be significant investment in basic research. Basic research is by definition patient and long-term research. The rate of return on basic research, at any reasonable discount rate, will be low. It must therefore be financed by either the government or non-profit institutions, and not by for-profit firms. The atomic and hydrogen bombs, the nuclear reactors, the internet, the packets transmission technology, and the browser are all outcomes of basic research done many years ago, often with government support. However, Chinese investment in basic research has remained low relative to the other major countries (see Chart 12). China has been devoting only 5 percent of its R&D expenditures to basic research, compared to the more than 15 percent of the U.S. and the more than 10 percent of Germany, Israel, Japan, and Russia. China must increase its expenditure on basic research if it aspires to be a global leader in science and technology. Moreover, in China (and other East Asian countries), there is a long cultural tradition of respect and reverence for age and established authority, so that questioning attitudes and challenges to accepted orthodoxy are very rare, which makes truly breakthrough discoveries and inventions less likely. This is something that China must try to overcome.

**Chart 12: Basic Research Expenditure as a Share of Total R&D Expenditure: Selected Economies**



Source: Lawrence J. Lau and Yanyan Xiong (2018), “Are There Laws of Innovation,” Working Paper, Lau Chor Tak Institute of Global Economics and Finance, The Chinese University of Hong Kong.

## 5. Sharing of Prosperity

The distribution of income in the Chinese economy is a separate issue altogether. It is interesting to note that both China before the economic reform and Taiwan until the 1990s had one of the most egalitarian distributions of household income in the world, despite very different economic systems. The Scandinavian countries, which also have different political and economic systems, have always had relatively egalitarian distributions of income. During the past couple of decades, the global distribution of income has become more egalitarian at the same time that within each economy, the distribution of income has become more unequal. This is the combined result of economic globalisation and technological innovation, which tend to create both winners and losers in each economy, increasing the income of certain special groups relative to the others.

While economic globalisation increases the welfare of every country and region in the aggregate, it creates both winners and losers in each economy in the process. The winners will be the exporters and the consumers and users of imports in every economy. The losers will be the domestic industries disrupted by the exports and the imports and their workers. Similarly,

technological innovation favors the educated and the highly skilled but not the uneducated and low-skilled labour. Moreover, the market system itself cannot and does not compensate the losers from either economic globalisation or technological innovation. Thus, in both cases, the income distribution tends to become more unequal. The Chinese economy is no exception. However, there is not the anger or frustration among the (relative) “losers” from globalisation or technological innovation as in the United States or Europe because almost everyone in China has become much better off as a result of the economic reform begun in 1978.

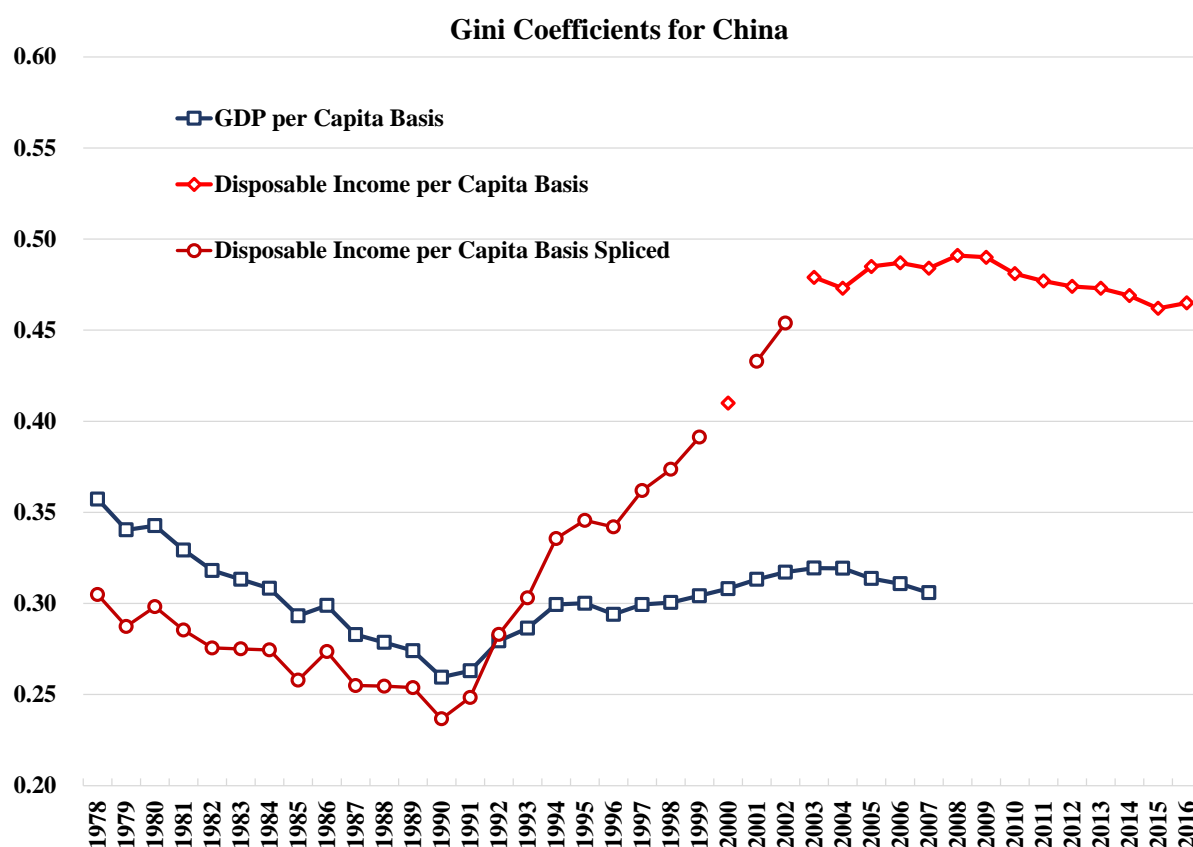
In Chart 13, two time series of the Gini coefficients of the Chinese economy are presented. The Gini coefficient is a measure of the degree of inequality of the income distribution—it takes the value zero for perfect equality, that is, everyone has the same income, and the value 1 for perfect inequality, that is, one person has all the income. A value of 0.5 is considered high. A rising Gini coefficient is an inevitable result of “letting some of the people become wealthy first”. The two time series of Gini coefficients are not really comparable. The Gini coefficient based on GDP per capita attempts to measure the distribution of income on a regional basis. The Gini coefficient based on disposable income per capita attempts to measure the distribution of income with household level data. However, regardless of whichever series is used, the overall picture is one in which the distribution of income improved after the beginning of economic reform until 1990 and then it began to worsen significantly until 2003, when it stabilised and started to improve again gradually. It is clear that the distribution of income has become considerably more unequal over time.<sup>3</sup> But perhaps this represents the high point of the inverted U-shape hypothesis of Simon Kuznets.<sup>4</sup>

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<sup>3</sup> The Chinese distribution of income is probably still not as unequal as that of Hong Kong or India.

<sup>4</sup> See Simon Kuznets, “Economic Growth and Income Inequality,” *American Economic Review*, Vol. 45, 1955, No. 1, pp. 1-28. For more discussion on the distribution of income in China, see Litao Zhao, “High Inequality Levelling Off in China,” EAI Background Brief No. 1346, East Asian Institute, National University of Singapore, 26 April 2018.

**Chart 13: The Gini Coefficients of the Chinese Distribution of Income, 1978–Present**



Sources: The Gini coefficient for GDP per capita, calculated on a regional basis, is taken from [China Development Report, 2009](#), p. 349; the Gini coefficient for disposable income per capita in 2000 is taken from the Research Institute of Statistical Sciences, National Bureau of Statistics of the People’s Republic of China, “Zhongguo Quannian Jianshe Xiaokang Shehui Jincheng Tongji Jiance Baogao (2011)”, 19 December 2011; the Gini coefficients for disposable income per capita in 2003–2016 are taken from [China Yearbook of Household Survey, 2011–2017](#); the Gini coefficients of disposable income per capita for the missing earlier and intermediate years are estimated by the author using a splicing technique.<sup>5</sup>

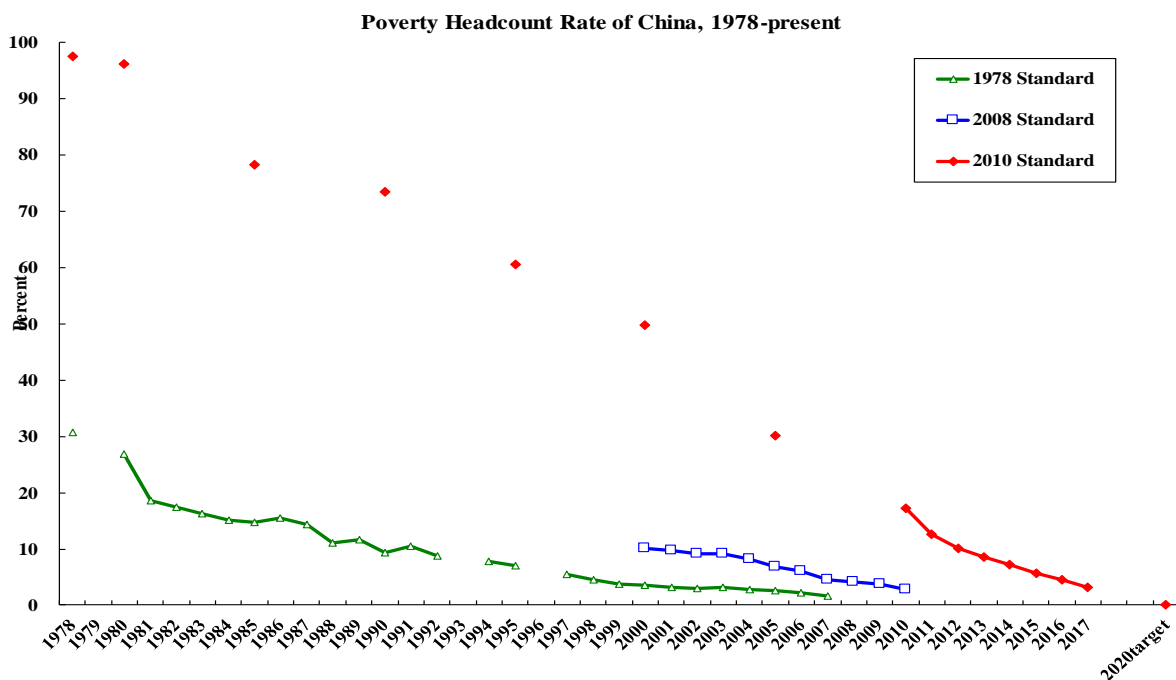
The Chinese labour share of GDP as well as its household share of GDP have been consistently significantly lower than those in other economies, developed and developing. It has hovered around 50%, whereas in most other economies it is between 60 and 70 percent. There is significant room for China to increase its labour share of GDP. One effective way to do so without changing entry-level wages is to steepen the slope of the wage-seniority profile in its initial phase, that is, to accelerate the wage increases due to seniority in the early years of an employee’s career, while maintaining the same level of terminal wage rate in real terms. This will enable the rate of growth of average wages to rise above the rate of growth of GDP for a couple of decades, which should eventually result in a higher share of household

<sup>5</sup> The spliced series is obtained by regressing the data of the Gini coefficient for the disposable income per capita on the data of the Gini coefficient on GDP per capita for the overlapping data years.

consumption in GDP more similar to other economies. Excess national savings will fall, and the Chinese trade surplus will eventually disappear.

In Chart 14, we present the poverty headcount rates of China according to different standards adopted in 1978, 2008, and 2010 respectively. The 1978 standard of poverty classifies households with a disposable income of below 100 Yuan per person per year in 1978 prices as living in poverty. The 2008 standard provides for a disposable household income of below 1,196 Yuan per person per year in 2008 prices. The 2010 standard, which is still the current standard, is the highest, classifying those households with a disposable income below 2,300 Yuan per person per year in 2010 prices, or approximately US\$1 per person per day at the 2010 exchange rate, as living in poverty.<sup>6</sup> Irrespective of which standard is used, the poverty headcount rate has been declining continuously since the economic reform began in 1978. If we apply the 2010 standard of poverty, over 95% of the Chinese population was below the poverty line in 1978. Today that share is below 5%, which means almost 1.3 billion Chinese people have been lifted out of poverty! It is expected that by 2020, poverty according to the 2010 standard will have been completely eradicated.

**Chart 14: Poverty Headcount Rate of China, 1978–Present**



Sources:

Poverty Headcount Rates: <http://www.stats.gov.cn/tjsj/ndsj/2017/indexch.htm>

2020 Target: [http://www.gov.cn/zhengce/content/2016-12/02/content\\_5142197.htm](http://www.gov.cn/zhengce/content/2016-12/02/content_5142197.htm)

<sup>6</sup> See the discussions on the National Bureau of Statistics of the People’s Republic of China web page: [http://www.stats.gov.cn/tjzs/cjwjtjd/201308/t20130829\\_74325.html](http://www.stats.gov.cn/tjzs/cjwjtjd/201308/t20130829_74325.html), accessed 14 May 2018.

## 6. Reducing Systemic Risks

The major risk to the Chinese economy is the potential systemic failure in the financial sector. The failure of a large enterprise may lead to the failure of its creditors, contractors, and suppliers, with significant spillover effects, especially if the degree of leverage of the enterprise is high. At year-end 2016, the total debt of all kinds to GDP ratio was 247% in China. It was believed to be more or less the same at year-end 2017. However, the central government debt to GDP ratio was below 20% at year-end 2017, compared to almost 100% for the U.S. and 250% for Japan. At year-end 2017, official local government debt was 16.47 trillion Yuan, and total local government liability was estimated to be around 31 trillion Yuan, or not quite 40% of a Chinese GDP of 82.7 trillion Yuan. The rest of the Chinese debt consists mostly of enterprise debt and household debt, for which the central government does not provide a guarantee and has no responsibility for repayment. There is a widely held but false assumption in the West that the state-owned enterprises will be bailed out by the Chinese Government. However, this assumption has very little factual basis because it is tantamount to having the shareholders bail out a failing firm, which no investor in the West will expect in general. The bankruptcy of Guangdong International Trust and Investment Corporation (GITIC), a Chinese state-owned enterprise, in 1999 should provide an example that the Chinese Government is unlikely to bail out failing enterprises unless they have provided an explicit guarantee.

In the third quarter of 2017, publicly listed Chinese enterprises had an average debt to assets ratio of 60% or a debt to equity ratio of approximately 150%, which is on the high side. But enterprises, unlike the government, have net assets (positive net worth). Moreover, almost all of the public debt and the great majority of the enterprise and household debts are denominated in Renminbi and held by Chinese nationals. So any problem should be quite manageable, especially given the high national savings rate of China exceeding 40 percent. Nevertheless, shadow banking, financial derivatives, and internet-related financial fraud can create significant problems if not adequately monitored and regulated.

## **7. Toward a Modern Socialist Market Economy with Chinese Characteristics**

### **Continuity of Governance**

One common feature of the early development stages of the East Asian economies is that they are all characterised by continuous one-party rule, beginning with the Liberal Democratic Party in Japan, the British Colonial Government in Hong Kong, the Kuomintang (Nationalist Party) in Taiwan, President Park Chung-Hee in South Korea, Prime Minister Lee Kuan Yew and his People's Action Party of Singapore, the National Front (Barisan Nasional (BN) and its predecessor, the Alliance) led by the United Malaysian Native Organisation (UMNO) in Malaysia, and then the Communist Parties of China and Vietnam. The advantages of continuous one-party rule are as follows:

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

(2) there is consistency, continuity, and predictability in economic plans and policies; and

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

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

President Xi Jinping wants to strengthen the Communist Party of China (CPC) so that it can provide the leadership for achieving the tasks of the new era. It is his intention to ensure the faithful implementation and execution of the policies adopted by the CPC under his leadership in a sustained manner. The party cadres should be transformed into a dedicated, selfless and incorruptible “priesthood”, with the primary goal of “serving the people”, so that the CPC can continue not only to survive but also to thrive for many more decades. Ultimately, all party cadres should be incorruptible not only because they are deterred by potential punishment, and not only because the operating system prevents them from becoming corrupt, but also because they genuinely do not wish to be corrupt. This has to involve a fundamental change in their basic values and a revival of the basic behavioral norms and virtues that used

to characterise the meritocratic scholar-officials class of past eras: that is, propriety (li), righteousness (yi), integrity (lian), and sense of shame (chi). Above all, they should not be motivated by personal gains. This is one sense of “socialism with Chinese characteristics”.

Under both the capitalist and the socialist market systems, there is an agency problem in the sense that the managers of the enterprises may not act in the best interests of the owners (shareholders) of the enterprises. Instead, they often act in their own best interests. This is the moral hazard. However, if the managers themselves can become more public-spirited and less self-centred, then the probability that their interests and those of the owners are more aligned is enhanced. Corruption is the result of an agent pursuing his or her own interests rather than those of the principal.

## **8. Projections of the Future**

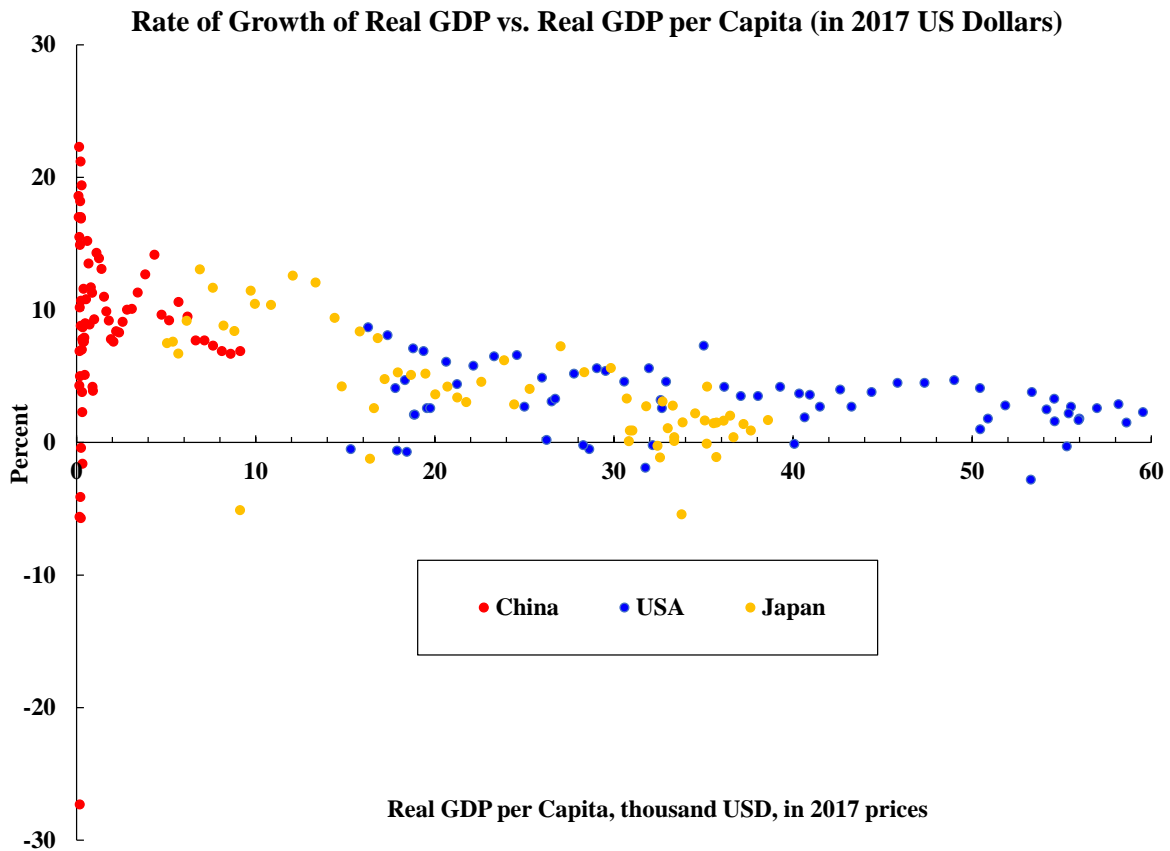
### **Long-Term Forecasts of the Chinese and the U.S. Economies**

We present some projections of the Chinese and U.S. real GDP during the new era and beyond. It is assumed that the Chinese economy will continue to grow around 6% per annum for a few more years, declining gradually to between 5% and 6%, and that the U.S. economy will grow at an average rate of 3% per annum between now and 2050. It may be thought that the Chinese economy will be unable to sustain an average annual rate of growth of between 5% and 6% for such a long time as experience shows that the rate of growth of an economy declines as its real GDP per capita rises. While this is decidedly true, given the still relatively low level of real GDP per capita in China, and the low level of its capital per unit labour, such a rate of growth should still be possible for at least several decades (see Chart 15, in which the experiences of China, Japan, and the U.S. are compared). Chart 15 shows that both Japan and the U.S. were able to maintain relatively high rates of growth of above 5% even when their real GDPs per capita were around US\$30,000. Our projections below show that Chinese real GDP per capita would only reach US\$20,000 in 2017 prices some time after 2030, so that the Chinese economy could likely continue to grow at these relatively high rates beyond 2040. In addition, there is still and will continue to be significant surplus labour in the Chinese economy. In 2016, the share of employment in the primary sector was around 30%, whereas the share of GDP originating from the primary sector was already below 10% (see Charts 16 and 17). It will take at least a couple of decades for the share of Chinese employment in the primary sector to decline



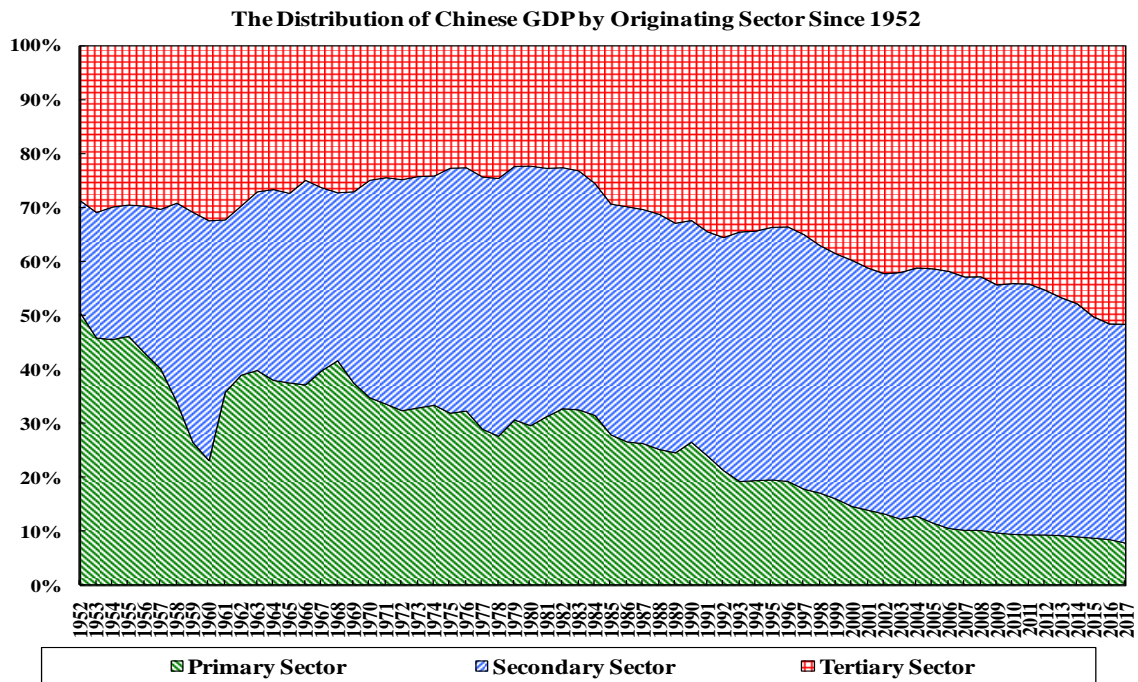
to the share of GDP originating from the primary sector. Thus, this surplus labour should provide an additional source of continuing Chinese economic growth. Furthermore, the Chinese tangible capital per unit labour is still low relative to those of the developed economies, which should allow the rate of Chinese economic growth to remain relatively high as its capital-labour ratio rises in the next several decades.

**Chart 15: Real GDP Growth Rate (%) vs. Level of Real GDP per Capita (2017 US\$): China, Japan, and the U.S.**



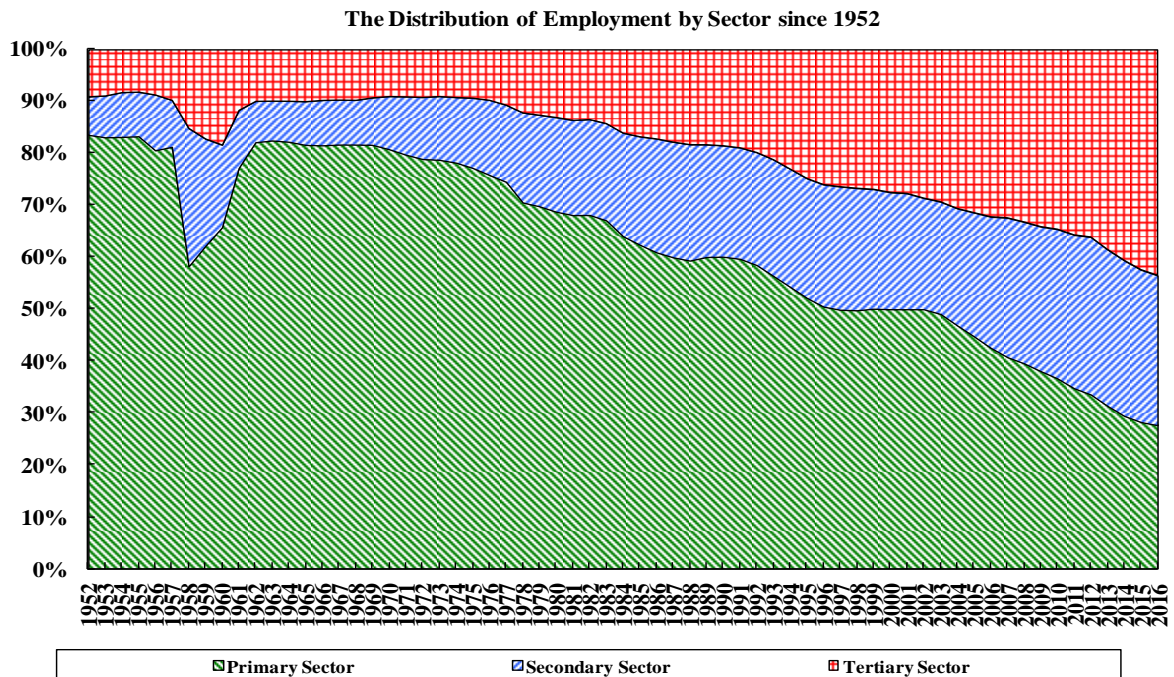
Sources: U.S. data are from U.S. Bureau of Economic Analysis; Chinese data are from National Bureau of Statistics of China; Japanese data are from International Financial Statistics.

**Chart 16: The Distribution of Chinese GDP by Sector Since 1952**



Sources: Data from 1952 to 1977 are based on China Compendium of Statistics 1949–2008; data for the year 1978 and thereafter are from National Bureau of Statistics of China (<http://data.stats.gov.cn/easyquery.htm?cn=C01>).

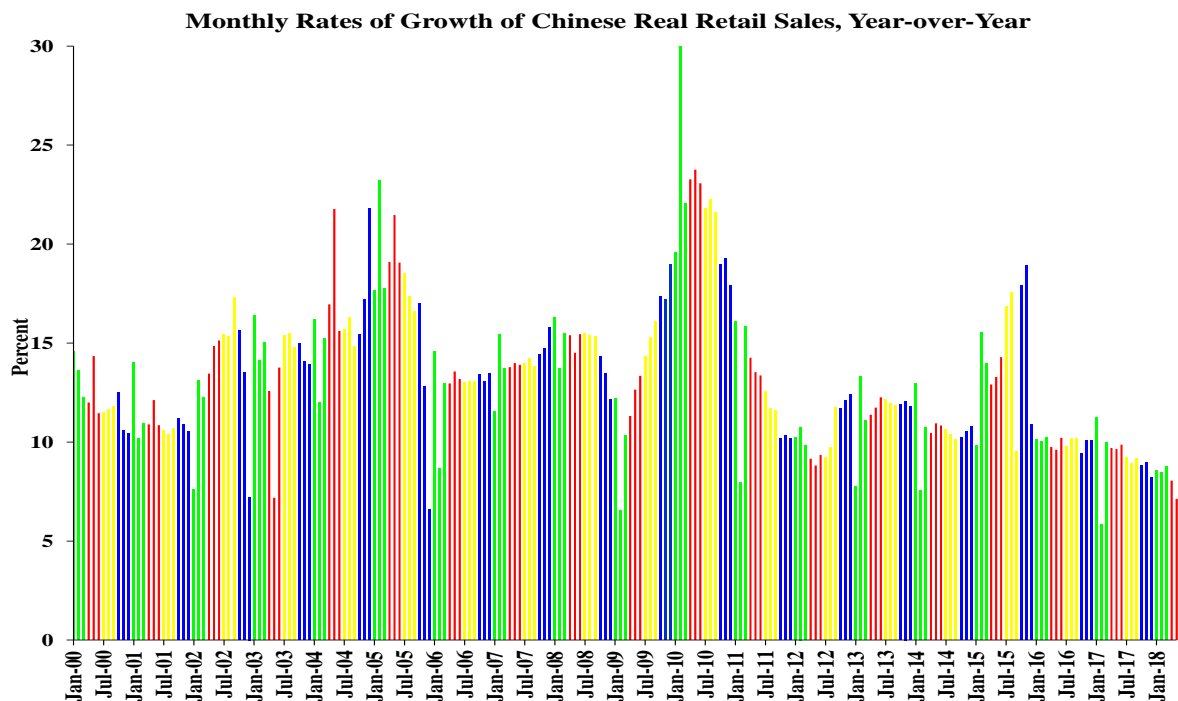
**Chart 17: The Distribution of Chinese Employment by Sector Since 1952**



Sources: Data from 1952 to 1977 are based on China Compendium of Statistics 1949–2008; data for the year 1978 and thereafter are from National Bureau of Statistics of China (<http://data.stats.gov.cn/easyquery.htm?cn=C01>).

The above discussion is mostly concerned with the supply side of the Chinese economy. Another question that may be raised is where the growth in Chinese aggregate demand will be coming from. The principal drivers of Chinese aggregate demand in the next several decades will come from the growth in household consumption and in public goods consumption such as environmental protection, preservation and restoration, education, health care and elderly care, and growth in investment in infrastructure, R&D, and innovation. Chinese real household consumption has been growing at approximately one and a half times the rate of growth of Chinese real GDP, supported by the rapid growth of the middle-class in China (see Chart 18). Moreover, the growth of public goods consumption will have the effect of equalising the distribution of real income, since everyone, regardless of the level of earnings, can enjoy the benefits of public goods. The growth of exports, and especially net exports, will no longer be an important component of the growth in Chinese aggregate demand.

**Chart 18: Monthly Rates of Growth of Chinese Real Retail Sales, Year-on-Year (Percent)**

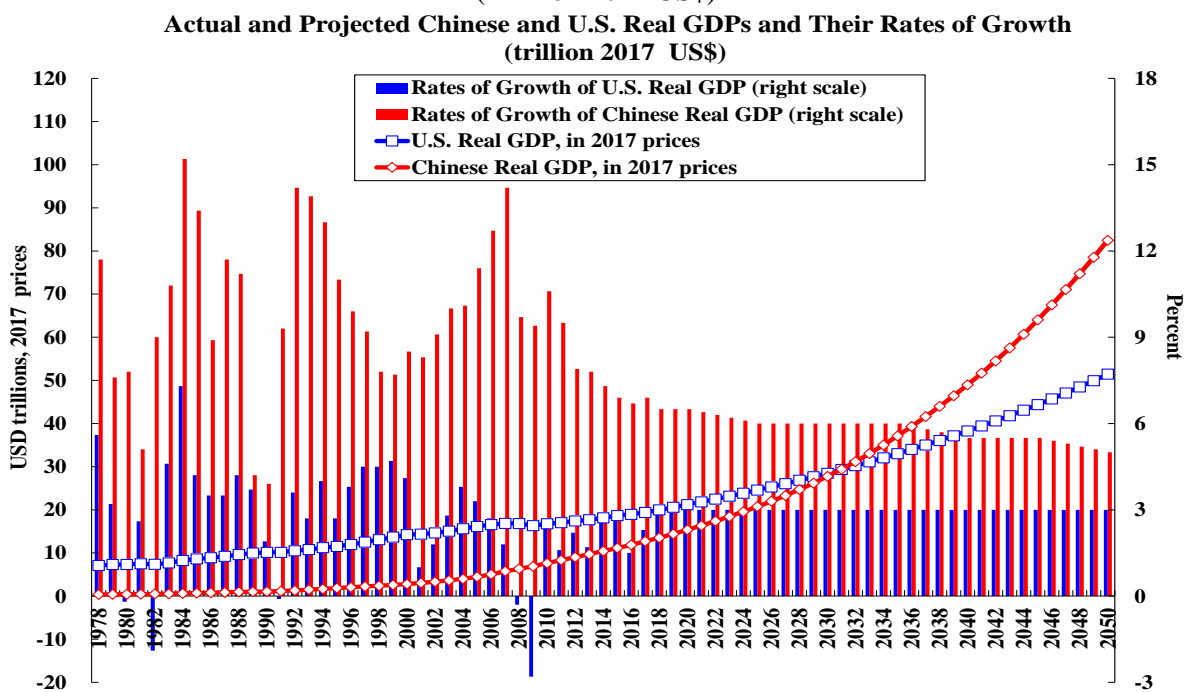


Source: [http://www.stats.gov.cn/tjsj/zxfb/201806/t20180614\\_1604561.html](http://www.stats.gov.cn/tjsj/zxfb/201806/t20180614_1604561.html). The nominal rates of growth of retail sales are taken from the National Bureau of Statistics of China (NBSC). The rates of growth of the retail price index are then subtracted from the nominal rates to yield the real rates of growth. (There are inconsistencies between the published values of retail sales and their nominal rates of growth in 2018M1–M5.)

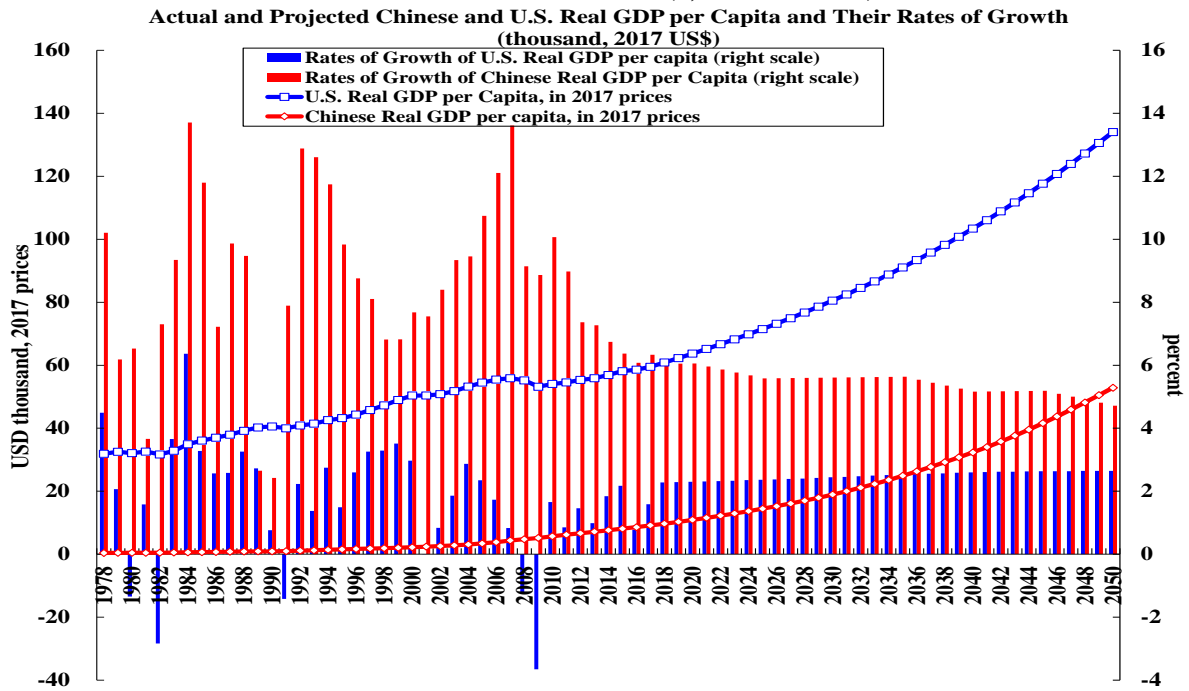
In his work report to the 19th National Congress of the Communist Party of China, President Xi Jinping identified three Chinese development milestones at 2020, 2035, and 2050 respectively. The first milestone is to become a moderately well-off society by 2020. Our

projections (see Chart 20) show that by 2020, Chinese real GDP per capita (in 2017 prices) will exceed US\$10,898, compared to US\$63,703 for the U.S. The second milestone is to become a modern and prosperous nation by 2035. Our projections show that by 2031, Chinese real GDP will surpass U.S. real GDP (US\$29.4 trillion versus US\$29.3 trillion), making China the largest economy in the world (see Chart 19). However, in terms of real GDP per capita, China will still lag behind significantly, with US\$20,009 compared to US\$82,502 for the U.S. (Thus, the Chinese economy should still be in a 5%-growth phase according to Chart 15.) The third milestone is to become a strong and wealthy nation by 2050. According to our projections, by 2050, Chinese real GDP will reach US\$82.6 trillion compared to US\$51.4 trillion for the U.S. In terms of real GDP per capita, China will reach US\$52,870, slightly less than the current level of U.S real GDP per capita, still significantly below the US\$134,071 of the U.S. It will not be until the end of the 21st century that the Chinese real GDP per capita can reach parity with the U.S. real GDP per capita, given that the Chinese population is approximately four times that of the U.S.

**Chart 19: Actual and Projected Levels and Growth Rates of Chinese and U.S. Real GDP (Trillion 2017 US\$)**



**Chart 20: Actual and Projected Chinese and U.S. Real GDP per Capita and Their Rates of Growth (1,000 2017 US\$)**



## 9. Concluding Remarks

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