China's road to prosperity[1]

Yu Yongding

Institute of World Economics and Politics
Chinese Academy of Social Sciences

2004-8-27

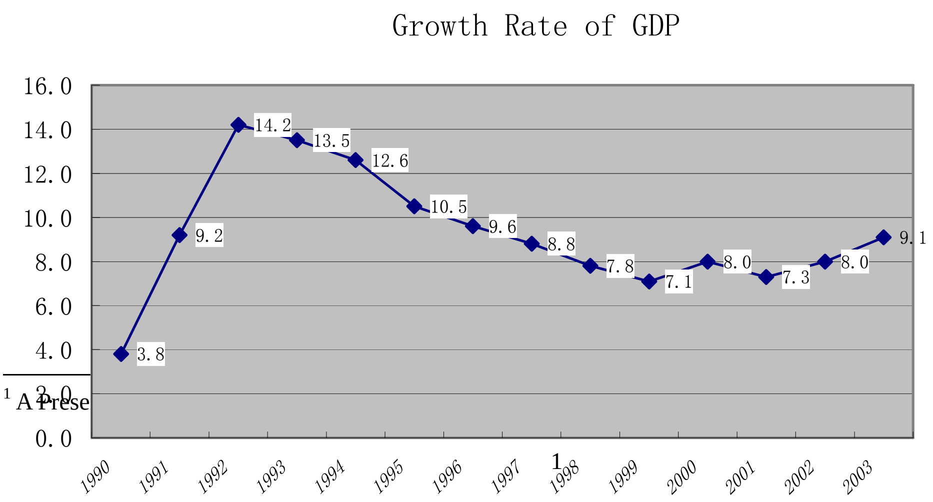
Over the past two decades, China's economy has registered an annual average growth rate of more than 9 percent. Now few foreign observers still have serious doubt about China's economic achievement. However, a fundamental question remains unsolved. That is, will China's economic growth sustainable? Will there be any major interruptions arise in China's growth process. Some Chinese economists are even asking the question of whether China will eventually be Latin -Americanized? My view of China's economic prosperity is one of cautiously optimistic. However, I would also like to emphaze that China's road for modernation will be rather bumpy. If the Chinese governmetn fails to solve many political, social and economic problems, China's endeavor for modernization still may suffer important setback.

I China's growth potential

History is the best guider for the future. Let's first check China's economic performance over the past ten years.

Since the reform and opening up in 1979, China's average economic growth rate is 9.3%. In the second half of the 1990s, China's growth rate has been stabilized at 7-8 percent per annum. Since the second half of 2002, the Chinese economy picked up strongly. In 2003, China's GDP

Figure 1 China's Economic Growth since 1990



[1] A Prese

Sources: State Administration of Statistics.

grew by 9.1 percent, the highest growth rate since 1997, and reached 11.67 trillion Yuan RMB, equivalent to 1.4 trillion USD at the current exchange rate. The inflation rate in 2003 measured by CPI was 1.2 percent, which signaled that the Chinese economy has finally shaken off the deflation that had plagued the economy since the second half of 1997. In the first quarter of 2004, China's growth rate accelerated to 9.7 percent, and CPI climbed 3.8 percent. The further heating of the economy aroused a significant amount of unease in the government and among economists. Some economists as well as the mass media coined the word "overheating" to characterize the current economic situation. Correspondingly, the government tightened economic policy to steer the economy towards a "soft landing". However, a more important question is what is China's potential growth rate, the growth rate that will not lead to serious inflation.

When we are talking about the long-term prospect of economic growth we are talking about the supply side of the economy. To analysis the growth potential we can use one of the following two equations.

$$n = \frac{s}{v}$$

$$or$$

$$n = p + \lambda$$

Here n is the growth rate; s is the saving rate; v is the capital-output ratio; p is the growth rate of labor productivity, and λ is the growth rate of labor supply.

The first equation says growth rate of the economy equals saving rate divided by the capital-output ratio. The second says the growth rate of the economy equals the growth rate of labor productivity plus the growth rate of labor supply. Due to the fact that China has a very high saving rate, as high as 40 percent, and a almost infinitive supply of labor force, even if China's efficiency is low, in other words, even if the capital-output ratio is high and the growth rate of labor productivity is low, China still can manage to achieve a long-term growth rate of 7 percent. Even though more thorough studies have yet to come by, a consensus view among Chinese economists is that China's potential growth rate is 8-9 percent.

II China's Financial and fiscal sustainability

Provided that China has a long-term growth potential of 8 percent per annum for the next decade, the key for the realization of this potential would be its macroeconomic stability. According to some influential American China expert outside China, the most serious threat to macroeconomic stability in China is the possibility of a domestic banking crisis. According to them, in China, nonperforming loans appear to have reached at least 25 percent, net of provisions. Thus China is well past the point at which a systemic banking crisis might be expected.

My belief is that, provided the Chinese government continues to tackle the nonperforming loan issues, owing to China's strong fiscal position (table 1), China can solve its problem of financial fragility.

Table 1 Changes in China's Main Fiscal Indicators (%)

	2000	2001	2002	2003
General fiscal revenues	17.6	22.4	15.5	13.7
Taxes	17.9	20.6	12.2	20.6
Central government revenues	20.5	22.8	10.0	10.0
Fiscal revenues/GDP	15.0	17.1	18.5	19.4
General fiscal expenditures	20.9	18.7	17.0	11.1
Basics construction	3.3	17.5	23.6	-2.1
Social security	62.5	33.8	35.0	17.4
Interest payment	1.9	7.3	-12.6	40.6
Basic construction expenditures/ General fiscal expenditures	13.5	13.4	14.1	12.4
Social security expenditures/ general fiscal expenditures	3.5	4.0	4.6	4.8
Interest payment/general fiscal expenditures	4.6	4.1	3.1	3.9
Interest payment/central government fiscal expenditures	13.2	13.6	10.6	13.1
Budget deficit/GDP	2.8	2.6	3.1	2.7
Debt incomes	12.5	10.1	23.3	13.7
Debt incomes/GDP	4.7	4.8	5.5	5.8
Debt incomes/central government revenues	59.8	53.7	60.2	62.2
Debt balance	25.0	17.7	20.0	34.5
Debt balance/GDP	14.8	16.3	18.3	22.7

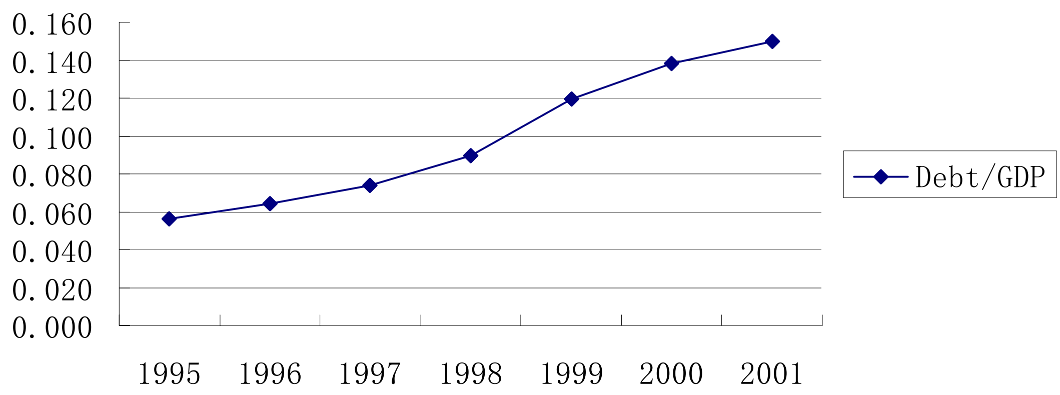
Sources: Fan Gang: Observation and Analysis of China's Macroeconomic Variables, Q1, 2004, for internal circulation.

The reason behind the improvement of government's fiscal position is the fact that despite the expansionary fiscal policy, government revenues have increased rapidly, which is truly amazing (Table 1).

The rapid increase in government revenues is attributable to strong economic growth and improvement in tax administration. Some increases are one-off. But many are not. As long as China's growth rate is above 7 percent, the increase in tax revenues will maintain a satisfactory speed.

As a result of the stabilizing of the budget deficit over GDP ratio and steady growth of the economy, the speed of the increase in China's accumulated government debt over GDP ratio has slowed down (Figure 2).

Figure 2 The Increase in Debt-GDP Ratio

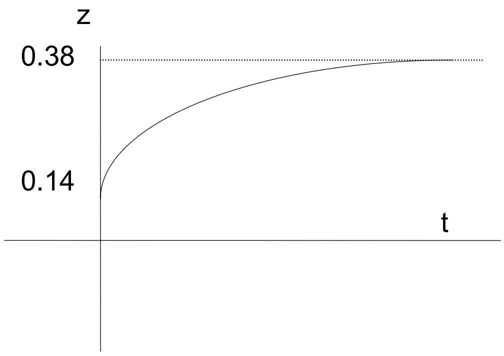


Sources: Before 1999 Figures are from "The Study Group of Fiscal Issue during the period of the 10th Five Year Plan", State Commission of Development and Planning. Other figures are from various other sources.

Some observers would argue that if taking into consideration China's contingent liabilities China's fiscal position would be much worse. In China contingent liabilities mainly consist of nonperforming loans, unpaid pensions, other possible expenditures for institutional reforms (medical cares, unemployment relief, and so on). Indeed, the truth of the matter is, if contingent liabilities have been considered, China's debt balance-GDP ratio would be as high as 50-100 percent according to different estimates.

It can be shown that given the budget deficit over GDP ratio and the growth rate of the economy, the debt balance over GDP ratio will approach a limit decided by the budget deficit over GDP ratio divided by the growth rate of the economy. For example, if the budget deficit/GDP equals 3%, and the Growth rate equals to 8%, the limit of the dynamic path of the debt/GDP ratio will be 38%. The initial condition (whether it is 100% or 14%)is not that important. The important thing is the growth rate. As long as we can control the budget deficit/GDP ratio and maintain a decent growth rate, the debt/GDP ratio will be stabilized at an acceptable level. The dynamic path of China's fiscal stability can be shown by figure 3.

Figure 3 The Dynamic Path of China's Fiscal Stability



Note: Official figure for China's debt balance over GDP ratio (excluding contingent liabilities) is 14 percent by the end of 2000.

In considering China's fiscal sustainability, one important factor must be taken into consideration. That is, Chinese households' saving behaviour. One of the most important features of the Chinese economy is Chinese households' high saving rate. As long as Chinese households' saving behaviour does not change much, the government will encounter no serious problem with selling government bonds. Despite the fact that the interest rates on government bonds today are very low, Chinese households are still queuing up for government bonds. This high saving propensity may have something to do with oriental culture. In Japan, due to the high saving propensity, despite the zero interest rate and a extremely high debt balance/GDP ratio, Japanese are still buying government bonds, and the yield of 10 year government bonds is still as low as less than 2 percent. In short, there are no convincing evidences and strong economic rationales that can show that China will face a fiscal crisis in, say, 5 years' time. I believe that as long as the Chinese government can avoid shooting its own foot in conducting macroeconomic stabilization policy and economic restructuring so as to maintain a decent growth rate and a relatively low budget deficit, China's fiscal position will be sustainable. China's economic prospect for the next decade is bright.

III China's Trade Policy and its External Position

Since the reform and opening up in the later 1970s, China has achieved amazing success in trade expansion. Just for two decades, China has completed the transformation from an autarky economy to the sixth biggest trading nation in the world. In 2003, China's total trade volume surpassed 851.2 billion US dollars, an increase by 37% percent over the previous year. The exports and imports in the year were 434.8 billion US dollars and 412.8

billion US dollars, respectively. The corresponding increases over the previous year were 34.6% and 39.9%, respectively. According to the WTO (on April 6, 2004), in 2003 China overtook France to become the fourth largest trading nation in the world. By import value, it outstripped Japan, Britain and France and climbed from the sixth to the third place, only after the United States and Germany. Over the past decades, China's trade has been consistently outperformed the world average (table 2).

With the total trade over GDP ratio being as high as 60 percent, China's openness has already surpassed almost all the major trading nations. China has become one of the most open economies in the world. While having benefited from the integration with the global economy, China has contributed to global growth significantly as the second most important locomotive of global growth since 2001.

According to General Administration of Customs, in the first quarter 2004, China's import and export value totaled US$239.85 billion, up 38.2 per cent over the same period of 2003. The import value was US$124.14 billion, an increase by 42.3 per cent. As a result, China has registered a cumulated trade deficit of US$8.43 billion in a quarter for the first time in many years.

Table 2 China's trade performance and FDI since 2000

	2000	2001	2002	2003	2004e
Growth of GDP					
world	2.5%	-1.2%	3.0%	3.2%	4.1%
China	8.0%	7.3%	7.8%	8.5%	8%
Growth of international trade					
world	12.6%	-0.1%	3%	3-5%	5-6%
China（in value terms）	32%	7.5%	22%	37.1%	20%
Growth of FDI					
World	29%	-41%	-21%	-10%	10%
Total flows，billion $	1392.9	823.8	651.2	560-600	600
China billion $	40.7	46.8	52.7	53.5	60

China's exports by region is characterized by heavy dependence on OECD countries. China's exports to Japan, the US and the EU account for over 60% percent of its total exports. Japan has been China's most important trade partner for 11 consecutive years. The US has been China's most important export market for many years. The NIEs as a group are China's second important trade partner account for less than 20 %. The ASEAN follows as the third leagion accounted for more than 5 % of China's total exports. China's imports by region are characterized by a similar pattern (table 2). Imports from the US, EU and Japan and the rest of OECD countries account for around 50% of the total. The NIEs account for approximately 30% and the ASEAN nations around 6% of the total.

China has succeeded in upgrading its export structure by raising the share of high value-added capital and technology- intensive products vis-à-vis low value-added labor-intensive products. In addition to the traditionally strong items, such as fabrics and handcrafted goods, there has been noticeable growth in exports of machines and electronic products of a relatively low technological level, such as color televisions, telephones, video equipment, etc. China's exports of machinery and electronic goods have exceeded those of fabrics, and accounted for more thant 30% of the total. China's imports of machinery and electronics account for 40% of the total, aound half of them are capital goods. In addition to its huge demand for imported machinery and equipment, one of the most important changes in China's trade structure in recent years is the dramatical increase in China's demand for energe sources and raw materials. For instance, China imported more than 90 million tons of crude oil in 2003; in the first two months in 2004, the import volume of crude oil already topped 20 million tons. It is estimated that in the next 20 years, in China the shortage of steel, copper, tin and many other raw materials will be huge, and most of them will rely on imports.

China has a very strong external position in terms of international balance of payments (Table 3).

Table 3 China's balance of payments

year	Trade	Services	transfer	Investment income	Current account	Capital account	FX reserves	Foreign debt
1991	87	0	38	8	133	80	217	605
1992	52	0	10	2	64	-3	194	693
1993	-107	0	1	-13	-119	235	212	836
1994	73	3	3	-10	69	326	516	928
1995	181	-61	14	-118	16	387	736	1066
1996	195	-20	21	-124	72	400	1050	1163
1997	462	-57	51	-159	297	230	1407	1310
1998	466	-49	42	-166	293	-63	1471	1460
1999	362	-75	50	-180	157	76	1547	1518
2000	345	-56	63	-147	205	19	1656	1457
2001	340	-59	85	-192	174	348	2122	1701
2002	442	-68	130	-149	354	323	2864	1685

Sources: International Balance of Payments of China, 1991-2002, State Administration of Foreign Exchanges (SAFE). The Tracking and Analyzing of China's Macroeconomic Variables, The Second Quarter of 2003, ed by Fan Gang, National Economic Research Institute.

The most important feature of China’s balance of payments is the persistence of the so-called “twin surpluses”. That is: the persistent current account surplus and capital account surplus. As a result of the “twin surpluses”, China’s foreign exchange reserves have surpassed 400 billion US dollars. It seems that this trend will not change in the near future.

In summary, as long as domestic savings are greater than domestic investment due to low returns in many potential investment areas, and as long as China still enjoy comparative advantage in labor-intensive products and some low capital and technology intensive products, China will continue to run trade surplus. On the other hand, as long as China can provide abundant cheap but skilled workers, a large army of trained engineers, and adequate infrastructure, which China certainly can, the attractiveness of China as a destination of FDI inflows will not abate. As long as China cannot fulfill the investment vacuum in industries that are at the higher rung of the ladder of international division of labor, due to the lack of the capacity that come with FDI, China will continue to attract FDI and concentrate on producing labor intensive products and to be satisfied with being the manufacturer of the world. As a result, the current pattern of international payments characterized by the twin surpluses will persist. Hence, no matter what resource allocation implications it has for China, so long as the pattern of international balance of payments does not change, China’s foreign exchange reserves will continue to increase and its external position will continue to be strong.

.

IV The Structural Problems of the Chinese Economy

Enough good things about China have been said. Despite all the success, China is and will be facing many Herculean difficulties. In other words, China is faced with serious challenges of structural adjustment that, compared with China’s short-run macroeconomic management, are far more fundamental and far more difficult to deal with. Structural adjustment will eventually determine whether China can successfully complete its long march towards the modernization of its economy.

Due to the time constraint, what I can do is just to give you a litany of structural problems and a very brief introduction on how China has dealt with them

(1) Ownership reforms: de-nationalization of state-owned enterprises and financial institutions. China’s Constitution was amended last year. The clause on the protection of private property was sharpened. It is declared in an important party document last year that the share-holding system should be the main manifestation of public ownership and no requirement for state control was mentioned in the same document. The Chinese understand well the importance of “representing assets with titles”. The bigger challenge is how to carry out ownership reform fairly and smoothly, so that state-assets stripping and embezzlement by corrupt government officials and

managers of state-owned enterprises can be avoided. An equally important issue is about the protection of farmers' rights on land-ownership and land use. "Enclosures" by local governments and real estate developers are endangering farmers' livelihood and the social stability. It should be emphasized that there is no plan for carrying out wholesale privatization in China. The public sector will continue to play a pivotal role in foreseeable future.

(2) Reform of the social security system: China's social security system is characterized by narrow coverage, poor service and lack of funding. Now the focus of reform is on that of the pension system. The objective of the reform is to establish a mixed system consisting of social pools and individual accounts. In other words, this should be a system comprising both the features of pay-as-you-go and pension funds. The main problem with the reform is the prevalent practice of the siphoning off funds from individual accounts onto social pools to meet the more urgent requirement of pension payment by retirees. China's medical care system and education system are also in a very poor shape.

(3) Urbanization: In China, rural population constitutes more than 70% of total population. In the US, the share is less than 2%. China's total population is 1.3 billion and will peak at 1.5 billion in the next two decades. According to some experts, in the next two decades or so, annually, there will be twenty million farmers migrating to urban areas. How to accommodate such huge migration politically, administratively, and economically is a Herculean task.

(4) The income distribution: In China the gap of income distribution between areas, urban population and rural population, and different social groups are widening rapidly. The ratio of incomes of urban resident to those of rural resident is more than 3. In Japan it is less than 0.9. China stands out as one of the worst in the world in terms of urban-rural gap. In coastal areas, urban population enjoys life as comfortable as western countries, and the life in hinterland could be as hard as you can image. Gini-coefficient in China is just under 0.5 (table 4), far above the warning line of 0.4. The implication of the widening gap of income distribution is crystal clear. However, how to deal with it is much less clear. Can China grow out off the minefield automatically before any mine explodes? Income redistribution via government budget? Moral persuasion? Unfortunately, people like Charles Dickens nowadays are endangered species everywhere, China included.

Table 4 Gini Coefficients for the top ten most unequal countries and China's Gini coefficient

Countries	Gini Coefficients
Sierra Leone	0.629
Brazil	0.601
Guatemala	0.596
South Africa	0.593
Paraguay	0.591

Columbia	0.572
Panama	0.571
Zimbabwe	0.568
Chile	0.565
Guinea-Bissau	0.562
Warning line	0.4
China (1994)	0.434
China (2000)	0.458

Sources: Yang Yiyong, Jingji Shibao, 2002/02/28

(5) Reform of the financial system: the first step is to commercialize state-owned banks. In this regard, China has gone as far as it can under current institutional arrangements. Since 1998, China has infused a large amount of money to raise Chinese banks' capital adequacy. Through debt-equity swap, Assets Management Companies enabled banks to strike 1.4 trillion non-performing loans off the book. Commercial banks also used their own profits to write off a large amount of NPLs. In 1997, China's NPL ratio was 35%. Now the ratio has declined to less than 20%. After receiving new injections in the form of FX, capital adequacy of the two of the big four state-owned banks has risen to above 8%. If the experiment is successful, more injections will follow. However, the financial reform is far from completed. The repeated capital injection may create moral hazard. The Chinese government hopes that enough strategic investors can be attracted to become shareholders of the state-owned banks. The efforts in reducing NPLs and raising capital adequacy are aimed at not only financial stability but also at the reform of the ownership structure of the state-owned banks. Whether this strategy will work, only time can tell.

(6) Relationship between the Central government and local governments: over the past three thousand years, at least, the Chinese have been struggling with the formulating of right relationship between the central government and local governments. China is a huge country. The central government must delegate a great proportion of political and economic powers to local governments that rule directly. On the other hand, local governments' efforts in maximizing local interests are often in conflict with national interests. For example, competition in attracting outside investment between localities leads to distortion of prices of factors of production, which in turn leads to serious misallocation of resources. The reform of central-local relationship is extremely complicated. It involves not only China's fiscal system, but also its political arrangements.

The litany will be long. However, in my view, the Achilles' heel of China's economic reform is the stunning gap of income distribution. It can be seen that China has already surpassed the threshold of the inequality that will endanger a country's economic development and social stability (Table 4). Even though China is still not among the worst in terms of inequality in income distribution, it is already bad enough for a socialist country, where public's tolerance and patience for inequality is wearing thin.

The China story is long. Unfortunately, I have to stop here. There is one thing I want to add. That is, despite all the serious problems, I am optimistic about China's economic prospects. The most important reason behind my optimism is that currently China has a very competent and hard working leadership, who are from the people and devoted to serve the people. All the problems have been dealt with head on under the current party and government leadership. Given time, all the problems can be solved and China will be able to realize its national dream of "peaceful rise".