JOINT ECONOMIC COMMITTEE

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RESEARCH REPORT #109-42
July 2006

FIVE CHALLENGES THAT CHINA MUST OVERCOME TO SUSTAIN ECONOMIC GROWTH

Since 1978, reform has transformed the People's Republic of China (PRC) from an impoverished autarkic socialist economy into a vibrant mixed economy open to international trade and investment. Real GDP growth averaged 9.7 percent from 1979 to 2005 and 10.9 percent in the first half of 2006.[1]

Economic reform has been incremental and pragmatic. Rejecting import-substitution as a failed development strategy, the PRC copied the successful export-promotion development strategies of Japan, South Korea, and other Asian economies.

The PRC's real growth in the two-way trade of goods averaged 13.7 percent from 1979 to 2005.[2] However, Japan, South Korea, and Singapore had similar or better trade performances than the PRC after the takeoffs of their economies.

The PRC's heavy reliance on foreign direct investment (FDI) distinguishes its development strategy from other populous economies in Asia. From 1979 to 2005, the PRC received a cumulative $633 billion of FDI.[3] The PRC has encouraged foreign multinational firms to establish Chinese subsidiaries to exploit the PRC's comparative advantage of abundant low-cost labor by:

- manufacturing labor-intensive, low-tech goods (e.g., apparel and footwear) for export, and
- assembling medium-tech consumer electronics and information technology products from imported parts for export.

These Chinese subsidiaries produced 19.1 percent of the PRC's value-added for industrial firms in 2003 (the last year in which comprehensive firm-level data are available)[4] and accounted for 58.3 percent of the PRC's exports of goods and 58.7 percent of its imports of goods in 2005.[5] Unlike Japan or South Korea twenty-six years after the takeoffs of their economies, the PRC has spawned relatively few Chinese multinational firms that manufacture own-design, own-brand goods for global markets.

Five economic legacies of the PRC's socialist past challenge its ability to sustain rapid economic growth in the future:

- unfavorable demographics;
- corruption and a weak rule of law;
- financially distressed state-owned enterprises (SOEs) and state-influenced enterprises (SIEs);
- a dysfunctional financial system; and
- domestic and international imbalances.

How the PRC responses to these challenges will affect the future performance of the U.S. economy.

Unfavorable Demographics

Declining Labor Force. Because of the PRC's one-child policy and rising per capita income, the PRC's fertility rate fell to 1.70 per woman during 2000-2005. Consequently, the PRC's working-age population (ages 15-64) should shrink after 2015.[6]

In major cities, the economic boom has already created a shortage of highly skilled workers and professionals, boosting their real compensation. At its current growth rate, however, the PRC will absorb its current supply of 140 million unemployed and underemployed workers within a decade. After 2015, a labor shortage should significantly increase the real compensation of all Chinese workers, forcing the PRC to shed many of its current jobs in labor-intensive industries and assembly operations.

Graying Population. Higher living standards have boosted the PRC's life expectancy at birth to 71.5 years during 2000-2005. Since the increase in longevity is expected to continue, the PRC's elderly population should increase to 320 million, or 23.0 percent of the total population in 2045.[7]

Unlike other major economies, the PRC lacks a comprehensive system of government old-age pensions or private retirement saving plans. Most elderly Chinese are dependent on their savings or their family for retirement income.

This lack of a social safety net drives Chinese households to save prodigious sums. In 2005, the

PRC's gross saving rate amounted to 49.1 percent of GDP.[8] Until the PRC develops a comprehensive social safety net, Chinese households are unlikely to reduce their extraordinarily high saving rate. Consequently, the PRC may incur difficulties shifting from export-led to domestic demand-driven economic growth.

Corruption and a Weak Rule of Law

The PRC has adopted a "rule by law," but still lacks a "rule of law." Individuals and private firms must rely on *guanxi* (i.e., connections) with officials to protect themselves and their property. During the last quarter century, economic reform has produced a *de facto* political decentralization that has allowed officials to exploit their *guanxi* to enrich themselves and their families through corruption.

Corruption is both widespread and costly. Transparency International reported that the PRC scored 3.2 on its *Corruption Perceptions Index 2005* (10 is corruption-free).[9]

Corruption, particularly the uncompensated seizure of land for development, fuels growing unrest. Mass protests soared ten-fold over twelve years, reaching 87,000 in 2005.[10]

Financially Distressed State-Owned Enterprises (SOEs) and State-Influenced Enterprises (SIEs)

Under the "grab the big, dump the small" policy adopted in 1997, the central government retained certain large SOEs. Many of these SOEs were subsequently converted into shareholding enterprises by issuing minority shares. Although shareholding enterprises exhibit many of the characteristics of private corporations, the central government still exercises effective control through its ownership of a majority of their shares. The remaining small- to medium-sized SOEs were converted into a variety of types of SIEs.

SOEs and SIEs remain a major part of the PRC's economy, producing 47.8 percent of the PRC's value-added for industrial firms in 2003,[11] employing 243 million in 2005,[12] and accounting for 74.1 percent of the PRC's investment in fixed assets in 2005.[13]

However, SOEs and SIEs are notoriously inefficient. The Organization for Economic Cooperation and Development (OECD) found that the total factor productivity (TFP) in private Chinese firms and Chinese subsidiaries of foreign multinational firms is double the TFP in SOEs, and one and one-half times the TFP in SIEs during 1998-2003 after controlling for size, location, and industry.[14]

Consequently, the average return on equity was 6.7 percent in all SOEs in 2003.[15] Moreover, the OECD found that financially distressed SOEs and SIEs accounted for 20 percent of the workers, 30 percent of the fixed assets, and 40 percent of outstanding debt in all SOEs and SIEs.[16]

SOEs and SIEs use their *guanxi* to secure favorable regulations and preferential access to loans from Chinese banks and other depository institutions. Consequently, many SOEs and SIEs face a "soft budget constraint" (i.e., Chinese banks and other depository institutions lend to the SOEs and SIEs without regard to their ability to repay their loans). Non-market loans allow many financially distressed SOEs and SIEs to continue operations and invest in new fixed assets when market discipline would otherwise force these SOEs and SIEs to cease operations or to forego the acquisition of fixed assets.

Dysfunctional Financial System

The PRC's financial system is very bank-centric. At year-end 2005, outstanding loans in banks and other depository institutions amounted to 107 percent of GDP. In contrast, the stock market capitalization amounted to 6 percent of GDP at year-end 2005,[17] and corporate debt securities amounted to 1 percent of GDP at year-end 2004.[18]

Despite some progress in developing credit evaluation and risk management skills, non-market criteria may still influence over one-half of loan decisions. While banks in other economies extend most of their loans to households and small- to medium-sized private firms, 64.5 percent of outstanding bank loans were extended to SOEs and SIEs.[19] Moreover, all of the proceeds from Chinese corporate debt and equity issues have gone to SOEs and SIEs.[20]

This non-market allocation of financing harms the Chinese economy in two ways:

- Non-market allocation has reduced the potential size of the PRC's GDP by $321 billion a year, or about 14 percent of its current GDP;[21] and
- Non-market allocation has slashed the average real return on the savings to a mere 0.5 percent over the last decade.[22]

Chinese banks and other depository institutions have a large legacy of non-performing loans

(NPLs). In 1999, officials transferred $170 billion of NPLs from the four major state-owned commercial banks to four asset management companies (AMCs) for liquidation. So far, these AMCs have disposed of 67 percent of these NPLs, recovering about 21¢ on $1 of face value.

The PRC reported that as of March 31, 2006, NPLs in commercial banks had fallen to 6.6 percent of GDP while NPLs in other depository institutions were 1.7 percent of GDP.[23] However, private estimates of total NPLs range between 27 percent and 41 percent of GDP.

To recapitalize ailing banks, the People's Bank of China (PBC) injected $60 billion of foreign exchange reserves into the four major state-owned commercial banks between 2003 and 2005. During 2005, foreign firms invested $18 billion in minority shares in Chinese banks. An initial public offering (IPO) of 13 percent of the shares raised $9.2 billion for the China Construction Bank in October 2005, while an IPO of 10.5 percent of the shares raised $9.7 billion for the Bank of China in May 2006.

In March 2006, the *Economist Intelligence Unit* observed, "[Q]uestions remain over whether risk management standards in the banking sector have improved in a way that would prevent such problems from re-emerging. One particular problem is the government's strong control over lending patterns, which encourages capital to be allocated on the basis of policy rather than profit."[24]

Domestic and International Imbalances

On July 21, 2005, the PRC broke its previous peg with the U.S. dollar, revalued the renminbi by 2.1 percent, and instituted an adjustable exchange rate tied to a basket of currencies including the U.S. dollar. During the year after this change, the PBC continued to intervene in foreign exchange markets by buying U.S. dollars with yuan. The PBC's intervention limited the appreciation of the renminbi against the U.S. dollar to 3.56 percent. Moreover, the PBC's intervention caused its foreign exchange reserves to swell to $941 billion on June 30, 2006.[25]

Given the PRC's financial controls, the renminbi is substantially undervalued by as much as 40 percent against the U.S. dollar.[26] This exchange rate policy contributes to both domestic and international balances.

Underconsumption and Dependency on Export-Led Growth. Chinese farmers are notoriously inefficient. The average productivity of a Chinese farmer is one-sixteenth of the average productivity of other Chinese workers. This widening productivity gap is increasing income inequality between urban and rural areas.

Under its accession agreement with the World Trade Organization (WTO), the PRC has opened its domestic market to agricultural imports. If the renminbi were to appreciate rapidly and substantially, many Chinese farmers could not compete with lower-priced agricultural imports and would cease farming.

Because millions are still employed in agriculture, currency appreciation could trigger mass unemployment and political instability. Under his "harmonious society" policy, President Hu Jintao is trying to increase rural income and provide alternative employment for displaced farmers by abolishing the two-thousand-year-old agricultural tax, expanding micro-financing for starting small businesses, and investing in mega-projects in rural areas. Consequently, Hu wants the renminbi to appreciate very slowly until the benefits of these measures become apparent.

However, this exchange rate policy creates profound imbalances in the rest of the PRC's economy. Intervention reduces the real incomes of Chinese workers and their consumption of imported goods and services. Consequently, the PRC cannot rely on domestic demand to drive its economic expansion. The PRC remains overly dependent on exports and investment for economic growth.

Overinvestment and Malinvestment. Despite sterilization efforts, the PBC's interventions in foreign exchange markets have provided excess liquidity to Chinese banks. Aggressive lending helped to boost the PRC's gross investment to 41.2 percent of GDP in 2005.[27]

Although the PRC's non-market allocation of financing may boost production and investment in the short term, the PRC's economic growth is sustainable over the long term if and only if firms:

- produce goods and services that the market demands; and
- invest in fixed assets that have a positive net present value.

The rapid accumulation of fixed assets among the SOEs and the SIEs suggests that overinvestment (i.e., the acquisition of too many fixed assets for producing goods and services given expected future demand) and malinvestment (i.e., the acquisition of the wrong types of fixed assets for producing goods and services to meet expected future demand) may be occurring. According to the *Economist Intelligence Unit*, "Oversupply has driven down prices in many industries."[28] Fueled by bank loans to SOEs and SIEs, speculation in real estate appears rampant in major Chinese cities.

An economic boom caused by overinvestment and malinvestment is not sustainable. The inevitable liquidation of overinvestment and malinvestment could cause a recession in the PRC and slow economic growth in the rest of the world.

International Imbalances. Because other developing Asian economies have labor-intensive industries and assembly operations that compete with the PRC, central banks in these economies fear that currency appreciation would put local firms or local subsidiaries of foreign multinational firms at a competitive disadvantage compared to Chinese firms or Chinese subsidiaries of foreign multinational firms. Thus, other developing Asian economies have mimicked the PRC's exchange rate policy.

The PBC and central banks in other developing Asian economies use their accumulated foreign exchange to buy foreign debt securities, mainly U.S. Treasuries and Agencies, creating a non-market financial inflow into the United States. Given the accounting relationship between the current account and the capital and financial accounts, this non-market financial inflow increases the foreign exchange value of the U.S. dollar, the U.S. current account deficit, and the U.S. financial account surplus above market-determined levels. According to some economists, if the PRC and other developing Asian economies were to float their currencies, the U.S. current account deficit could decline by up to 10 percent.[29]

Conclusion

Although the Chinese economy is booming, the PRC faces five major challenges to sustain rapid economic growth in the future:

- unfavorable demographics;
- corruption and a weak rule of law;
- financially distressed SOEs and SIEs;
- a dysfunctional financial system; and
- domestic and international imbalances.

Senior officials are aware of all of these problems. However, the fear of short-term economic dislocations that might ignite political instability constrains senior officials.

Instead, senior officials have chosen to address these challenges through gradual policy changes. A more comprehensive approach is needed to resolve these interrelated problems.

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[1] China National Bureau of Statistics (NBS)/Haver Analytics.
[2] International Monetary Fund/Haver.
[3] NBS/Haver.
[4] *OECD Economic Survey: China* (Paris: Organization for Economic Cooperation and Development, 2005): 133.
[5] NBS/Haver.
[6] United Nations Population Division, *World Populations Prospects: The 2004 Revision Population Database*, http://esa.un.org/unpp/p2k0data.asp.
[7] Ibid.
[8] Author's calculation based upon NBS/Haver data.
[9] *Transparency International Corruptions Practices Index 2005*, found at http://transparency.org.
[10] Found at: http://www.chinabalancesheet.com/Documents/Data_Domestic_Sociopolitical.PDF.
[11] For industrial firms. OECD: 126.
[12] NBS/Haver.
[13] Author's calculation based on NBS/Haver data.
[14] OECD: 86.
[15] OECD: 105.
[16] OECD: 102-104.
[17] Marketable shares only.
[18] Author's calculation based on People's Bank of China (PBC)/Haver data.
[19] Ibid.
[20] Diana Farrell et al., *Putting China's Capital to Work: The Value of Financial System Reform* (McKinsey Global Institute, May 2006): 15.
[21] Ibid: 81.
[22] Ibid: 90-91.
[23] Author's calculations based on China Banking Regulatory Commission/NBS/Haver data.
[24] Economist Intelligence Unit (2006): 30.
[25] PBC, State Administration of Foreign Exchange, and NBS/Haver.
[26] Morris Goldstein, *Renminbi Controversies*, Prepared for the Conference on Monetary Institutions and Economic Development, Cato Institute, November 3, 2005, revised December 2005): 1-4.
[27] Author's calculations based on NBS/Haver data.
[28] Economist Intelligence Unit (2006): 25.
[29] C. Fred Bergsten, "Clash of the Titans," *Newsweek* (international edition), April 24, 2006.