Facing Challenges: Economic Prospects and Policy Choices in China

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The world is changing China; China is also changing the world. The Chinese economy has been growing at double-digit rates in recent years, and the year 2007 reached an important milestone in modern economic history. During that year China for the first time contributed more to global GDP growth than the US. Although the current size of Chinese economy is roughly 1/4 that of the US, if China continues to grow at 10% and the US at 2%, China will be adding more to global GDP each year than any other country for the foreseeable future. A PricewaterhouseCoopers report suggests that the Chinese economy could overtake the US economy in around 2025, and will continue to grow to around 130% of the size of the US by 2050. Should we take the projections seriously? In the long run, I believe optimism is warranted, and the reason is simple. It is China's demographics of 1.3 billion people, coupled with its sustained efforts to build a rule-based market system that has been driving the economic growth. Last year for instance, after years of deliberations, China finally enacted its Property Law and Anti-trust Law -- critical ingredients of a market system. Now that China has those on the book at least; the challenge is implementation. These are very positive strategic moves for China's long-run prospects. In short term though, do not be surprised there are bumps on the road.

It is important to note also that the Chinese economy is increasingly integrated with the world and with the US in particular. Foreign trade contributes a significant portion of China's GDP. Export alone shot up to 38% of the country's GDP in 2006 and from 20% in 2001, and the US is the biggest trade partner of China, with 21% of Chinese exports currently going to the US. In the wake of the sub-prime financial turmoil in the US[1], while it would be premature to conclude that the US will slide into a recession, signs are strong, however, that its economy is slowing down remarkably. One would wonder how much effect this will have on China.

Chinese Premier Wen Jiabao has warned that 2008 would be "a most difficult year," and that "there are uncertainties in international circumstances… and there are new difficulties and contradictions in the domestic economy." How do we interpret his remarks and what policy implications do his remarks have for the Chinese economy in the near future?

To answer these questions, it is important to recognize at the outset that the current growth pattern of the Chinese economy has been propelled primarily by three drivers – exports, fixed investment, and domestic consumption, and that the policy objective

[1] According to Global Insight, there are roughly 1.2 trillion in securitized sub-prime loans in the global financial system. If only 10-20% gone bad, the write-down on portfolios will be in the 120-240 billion range.

of macroeconomic adjustments of the country has been to rebalance the three drivers away from heavy reliance on exports and investment to domestic consumption. Let me outline recent economic developments along the line of the three drivers with some statistics

Statistics show that in recent months the Chinese economy has started to slow down somewhat from its record growth rates. Although GDP grew 11.4% in 2007, making it 5th consecutive year with double digit growth, last year growth was stronger in early than in late months. The slowdown is apparently due to a declining contribution of exports, as external demand has softened. The impact of the exports on the overall GDP growth is somewhat offset by stronger domestic demand. Noteworthy is the growth of retail sales last December accelerating to 20.2% over the same period in 2006. But it is too early to tell whether more general rebalancing of the pattern of growth is indeed shifting away from exports and investment to consumption. One reason is that the accelerated sales figures are nominal, and inflation could be a factor. The other is that strong domestic consumption so far may be due to the positive wealth effects from significant rise in stock prices over the past two years. That may be transitory, now that share prices have plummeted more than 40% from their peaks about six months ago.

Overall, exports and fixed investment remained principally responsible for the high growth rate of 2007. China's trade with the rest of the world has been growing three times as fast as the world average since its accession to the WTO in 2001. If it keeps up the momentum, China will become the largest exporting economy in 2009. Statistics show that that the trade surplus surged by 48% in 2007 to a record high of US$262.2 billion. Total exports rose by 26% to US$1.22 trillion, and imports grew by 21% to US$955.8 billion. Exports were boosted by the strong performance in the textile and footwear sectors, while other sectors, notably electronics and metals, also witnessed acceleration in shipments.

Fixed-asset investment (FAI) rose by 25% from the previous year. Correspondingly Industrial output rose by 18% on the same year. Foreign direct investment (FDI) rose to another record high of US$74 billion in 2007, up 13% from a year earlier, with capital inflows boosted further by rapid growth of foreign private equity (PE)[2] and other undocumented "hot money." Swollen by the twin surpluses on the capital and current accounts, foreign-exchange reserves rose by 40% on the year to US$1.53 trillion, making China the world’s largest holder of foreign exchange reserves. In spite of efforts to cool down the economy, credit growth continued to be fuelled by the expansion in the money supply, albeit unintended. Excessive liquidity has been inflated in part by the Central Bank’s intervention to neutralize the impact of surging

[2] Investment from private equity funds reached US$738 billion in 2006, of which US$11.7 billion were invested in the Chinese market, and the figure for 2007 was US$10.6 billion, according to statistics from Zero 2IPO, a service provider of China's venture capital and private equity sector.

foreign capital inflows on the exchange rate, and much of it has been funneled into property and the stock markets. There are serious concerns that the economy is overheating and its asset markets are quite bubbly.

As indicated above, the current pattern of China’s growth presents challenges for its economy. The country’s export-driven t and fixed investment development model means more factories to produce more goods and much of them for the world markets. Economically, this has left China quite vulnerable to growth slowdowns elsewhere in the world, and particularly in the US. Politically, environmental concerns and trade protectionism have already arisen, posing additional challenges to Chinese policy-makers. As growth in China is heavily linked to exports, the slowdown in the global economy is bound to affect China’s economy. The question is to what extent? Although Chinese financial institutions have had low direct exposure to the sub-prime financial crisis in the US, due much to its capital market restrictions and controls, the main impact of the international financial turmoil on China could come via the real economy especially in the tradable sectors.

Weaker growth prospects in the US mean lower interest rates -- as indicated by the rapid reduction in the US Fed interest rates in recent months -- and a weaker US dollar against other major currencies, which would depress US appetite for imports. Even worse, a bursting of the US property bubble in conjunction with the sub-prime crisis-related deleveraging and a downshift in labor income could put an end to the spending binge for credit-driven US consumers. If this scenario happens, then the Chinese economy will take a hit. Indeed, this scenario must have loomed large on the Chinese Premier’s mind when he said that 2008 would be “a most difficult year,” and that “there are uncertainties in international circumstances…”

Under normal circumstances, however, the slack created by a smaller export contribution to GDP growth could be picked up by increasing fixed investment. But concerns over overheating and inflation have made this macroeconomic policy tool very difficult, if not altogether unavailable, to policy-makers in 2008. That is why Chinese Premier Wen Jiabao commented that “there are new difficulties and contradictions in the domestic economy,” as macroeconomic policy needs to address the challenges of containing inflation and boosting domestic consumption simultaneously

Inflation rose considerably. According to the National Bureau of Statistics, China’s the Consumer Price Index (CPI) rose 7% in January 2008, and now at above 8%, the largest increase since December 1996. The dramatic increase was mainly driven by the 18% increase in food prices, which accounts for 1/3 of China’s consumer basket. Pork prices, which seriously affect Chinese households, led the food category with a 58% increase over the previous year. The price of other important commodities such as cooking oil and grain were also up by 37% and 5% respectively. Residential utilities, a category including the price of water, electricity and fuels, building and decoration materials, and renting also increased by 6%, further burdening the average Chinese household. This prompted policy-makers to impose several administrative measures, including some temporary price controls in an attempt to manage expectations, especially in light of the very unusual weather patterns of snow storms early this year that disrupted transportations and power supplies in south China. Understandably, while price controls in the long run block the transmission of price signals to producer to increase supply, the benefit of price controls in the short term may well outweigh the detrimental effects. This is so because inflation remains a highly politicized issue in China, accentuated by intensifying income inequality – another difficult front where the government is hard at work to achieve a so-called “harmonious society” that would benefit all of its citizens.

Sharp increases in global prices of industrial commodities have also driven up China’s raw material prices. According to the National Bureau of Statistic, the Producer’s Price Index (PPI) also rose by 6% year in January 2008, with the costs of raw materials, fuel and power up by 8.9%. Given its increasing dependence on imported raw materials (by 2006, China consumed 32% of the world’s steel, 30% zinc, 25% aluminum, 23% copper, and 18% nickel), the Chinese economy is particularly vulnerable to global inflation partly caused by the depreciation of the US dollar against other major currencies. In response, if only nominally the RMB appreciated consistently against the US dollar since the lunar New Year holidays of 2008, now breaking the 7 watershed in an attempt to hold back excessive liquidity and fight inflation. This follows in the heels of the Central Bank’s moves to raise the bank’s reserve ratio 10 times and interest rates six times in 2007. It is against this backdrop that China has raised the total for individual foreign exchange purchases to US$50,000; and that China has also allowed Qualified Domestic Institutional Investors (QDII) to go overseas, and that in particular, it established the Chinese Investment Corporation (CIC) in 2007, its first sovereign wealth fund with $200 billion --- all with a clear mission for promoting capital outflows.

In light of these developments and prospects, other key macroeconomic issues that Chinese policy-makers have to deal with can be summarized as follows: (1) the likely impact on China of the prospective global slowdown triggered by the sub-prime lending crisis in the US; (2) inflation; and (3) domestic consumption.

With respect to the first key issue, it is critical to have a view on how the overall macroeconomic policy stance should be adjusted in light of changes in the outlook of the world economy. Given the high degree of uncertainty, vigilance and flexibility is required, as echoed by Chinese Premier Wen Jiabao, and I quote him: "China is a developing country with a population of 1.3 billion, which demands us to keep the economy at an appropriate growth rate to confront the employment pressures…We shall keep a close eye on economic changes and trends, take timely and flexible measures, and have a good command of the pace, direction and intensity of macro-control measures to ensure a steady and fast economic development, employment of about 10 million people."

Given uncertainties in the outlook, it is premature to judge what is the appropriate stand on the existing tightening measures to control investment. Agility is key. In case of a mild global slowdown, a somewhat weaker global economy means a somewhat weaker demand for China's exports and somewhat lower international commodity prices. This actually could help China's macro-economic objective by cooling down its overheated economy, lowering inflation, and reducing the trade surplus. Indeed, growth rates consistently and considerably above 10% are not sustainable and risk inflation. A modest slowdown may be a good thing for China.

In case of a more pronounced global slowdown, however, there is also reason to believe that China also has the fiscal wherewithal to stimulate the economy. Its tax revenues have grown up consistently over the years from 10.8% of GDP in 1998 to 21% in 2007. In fact, with the government's growing slice of the pie, it is somewhat ironic that policy makers so far have been constrained in dealing with real social issues such as poor rural health care and schools, partly because overall the economy was in danger of overheating in recent years. Therefore, if there is a serious downturn in domestic demand as the global economy slows significantly, China is reasonably well-positioned to increase its spending on social services and infrastructure, meeting real social needs and keeping the macro economy on track. Total domestic investment was US$1.96 trillion in 2007 and is likely to remain at least at that level for 2008. The bottom line is that China must be agile with its macroeconomic policy as the uncertainties of 2008 unfold, but with good management it can continue to grow at 9% and above.

Inflation is the biggest challenges for policy-makers in 2008. There are sporadic reports that labor costs are also on the rise. But the good news is that price increases, while dramatic, are due more to specific structural changes than any classic causes of general inflation. So far there is limited spill over of higher food prices into more generalized inflation and no obvious overall excess demand exists, although there are risks. Such being case, the government's objectives are to contain overall inflation at a reasonable level and to ensure that supply of goods on key markets increase to meet demand. It is critical to be aware that food inflation is felt most by the hundreds of millions of Chinese farmers and migrant workers, such as those swarming over the last major projects being completed in Beijing for this summer's Olympic Games, but whose incomes are only fractions of those of urban residents. Recent price hikes must have made their marginal lives even harder. But in a longer run, it should be understood that food price increases help Chinese farmers, and that the current hikes of food prices may actually reflect that they may have been short-changed in the heady rush of industrial urbanization in China.

The current levels of inflation stand as a warning sign to policy-makers but also present them with a chance to practice a more sophisticated from of economic management than previously. They must remember that over-reaction with a strong interventionist approach to the inflation in the mid-1990s deepened the deflationary crisis that followed. This time policy-makers must learn to balance the need to control inflation in the short term with the need to improve efficiency in resource allocation in the long run. Given China's solid fiscal position, the government could consider replacing some price controls with subsidies targeted at needy groups. Indeed, the National Reform and Development Commission, which issued price controls, indicated that price controls should be abolished as soon as price pressures have abated, and overall, short-term consideration should not distract from the strategic direction of China's market-oriented reforms.

Finally, the issue of domestic consumption. The recent slowdown in the global economy and the flattening of Chinese exports to the US should stand as another warning signal that China can't afford to grow its economy believing that external demands will forever be on the rise. The ultimate answer lies in macro rebalancing – that is shifting the country's growth pattern away from exports and investment toward one that rests more firmly on domestic demand, especially private consumption. The job won't be easy. But all things considered, it is China's only hope for a better macro balance that is essential for sustainable and long-term growth.

China has already started to instill more of a pro-consumption growth dynamic. Since the Asian financial crisis in 1997, China has attempted to reduce reliance on investment and exports and turn to consumption through tax cuts, minimum wage rises and improved education. In particular, in line with the basic thrust of the country's 11th Five-year program, the government now is hard at work on creating a safety net, especially a national social security system, pensions, and expanded medical care and education. It is estimated the country's consumption rate could be raised by more than 3 percentage points, if the government spent more on education and healthcare. To put in place a better system of pensions, healthcare and education is essential to overcome the bias toward precautionary high Chinese savings.

Statistics show that the country's retail sales were $1.2 trillion in 2007, up 16.8% year on year. The growth, in itself, does not look so remarkable when compared with the 11.4% growth of the economy in 2007, the fastest in 13 years, on the back of a 47.7% jump in the trade surplus and a 24.8% rise in fixed-asset investment. But it marks an increase of 3.1 percentage points in consumption growth over the previous year while that of net exports and investments either dropped or flattened. That means domestic consumption made a greater, though still small, contribution to the country's GDP growth. This is good news. The shift in growth away from investment and exports toward private consumption is welcome. To facilitate it, policy-makers should come up with more fiscal incentives this year to further boost domestic consumption.

The bad news is that a fully fledged consumer culture will all take time to develop – quite possibly much more time than most believe. Yes, there are signs of a consumer culture starting to take hold in some of the urban pockets of the most developed

Chinese coastal cities, and brand-names such as Adidas, Porsche SUVs, Louis Vuitton, Carrefour, Salvatore Ferragamo, Versache, Gucci, P&G, Yum! and other global companies have surged into China over the past years. But with the nation's overall private consumption share stood at just 35% of GDP in 2007, these developments remain exceptions. In the case of the US, the share of consumption is about 70% GDP. If that is an indication of a consumer culture, the challenges remain as daunting as ever for China to boost its domestic demand by developing a pro-consumption culture. And beyond macroeconomics, more fundamental social and political problems loom just as large -- resource depletion, environmental degradation, political corruption, and the widening gap between rich and poor, with Gini coefficient now reaching 0.46 in China (0.47 for US; 0.34 UK; 0.31 France; 0.25 Japan). The plate is quite full. The job must start to tackle these problems as well, and can't be delayed.