

Rethinking China's Economic Development in 2008

By Ke LONG



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CHINA'S economy has grown dramatically in the past three decades, and the economic growth ratio has reached double digits annually since 2003. It is considered that China could sustain this high level of economic development in 2008 because of the demand of the Beijing Olympics. Moreover, rapid economic development may be continued in the coming years, at least until 2010, driven by the Shanghai Exposition.

It seems, however, that the economic growth will not be smooth because market players such as SOEs (state-owned enterprises) and SCBs (state-run commercial banks) are facing some structural problems. It is clear that the Beijing Olympics (2008) and the Shanghai Expo (2010) are making enterprises, especially SOEs, and institutional financial investors very positive towards investment. However, it has been pointed out that investments by SOEs under the soft budget restraints are highly inefficient. The balance sheets of SOEs and SCBs are going to be worse after the investment boom, which means SCBs will be saddled with a large number of non-performing loans. Current reports from the CBRC (China Banking Regulatory Commission) show that non-performing loans held by SCBs are currently increasing as a result of economic overheating and the unstable housing and stock markets.

On the other hand, an overheating economy makes the inflation ratio rise, which in turn will bring instability to society. From July 2007, the pace of rise in the CPI accelerated to 6.1%; furthermore, it reached 7.1% in January and 8.7% in February 2008 (*Chart 1*), recording the highest level during the past decade. The reason for this inflation is simply because food and energy resources prices are going up currently. The inflationary trend is expected to lower household consumption, especial-

ly among low-income households. The percentage of low-income households is estimated at about 60% of all households in urban areas and almost 90% in rural areas. Therefore, for policymakers in the State Council and the People's Bank of China (the central bank), it is important to cool down the overheating economy as soon as possible, especially fixed-asset investments, and meanwhile to bottom up the low-income bracket.

Income Reallocation

The characteristic of China's "Open Door and Reform Policy" is to deregulate and decentralize direct economic control by government officials and the Communist Party. Such deregulation and decentralization give domestic enterprises and individuals a strong incentive to work hard to produce more output. This kind of Chinese-style "Gradualism" is characterized by differing from the "Shock Therapy" enforced in the East European countries and Russia, and aims to create a new market-oriented system by experiments, while partially keeping the old regime. Under such reform, individuals change themselves to become more active in business and market activities, whereas before they could only follow government officials and policies passively.

Another point of view about China's economic reform is to improve market-based competition. According to OECD estimates, more than 95% of retail prices and about 97% of food prices have been liberalized, but before that they were directly controlled by government officials. Now most of the prices have been decided by the market mechanism. Here it must be pointed out that while the improvement of competition drives strong economic development, the competition itself is not fair and lacks transparency. Although the economic growth

ratio reached an annual average of 9.6% over the past three decades, income disparity has rapidly become a serious issue. According to World Bank estimates, the Gini Coefficient has reached 0.47, which means Chinese society is going to become more unstable in the coming years. The Hu Jintao administration is currently planning to change the economic development model to try to bottom up low-income households, not only in urban but also in rural areas. It seems, however, that these kinds of projects and policy mix do not work as expected.

First, the political institution and the market-oriented economic system are mismatched. Under this kind of paradox of the current systems, it is difficult for the low-income class to catch up because they have a different starting line with different initial conditions. Second, the function of the taxation system to reallocate income between the rich and low-income classes is extremely weak. According to the Chinese government's official report, the top 10% of the rich class of the total population only pays a 30% private income tax, which seems too low compared with the top marginal rate of 80% in America. Third, political system reform has not started yet. Low-income households cannot affect government decisions to be friendlier to the low-income class. China doesn't have a democratic election system. Moreover, the current political system and policy decisions lack transparency, creating a highly unfair system for low-income households.

Over-investment and Over-capacity

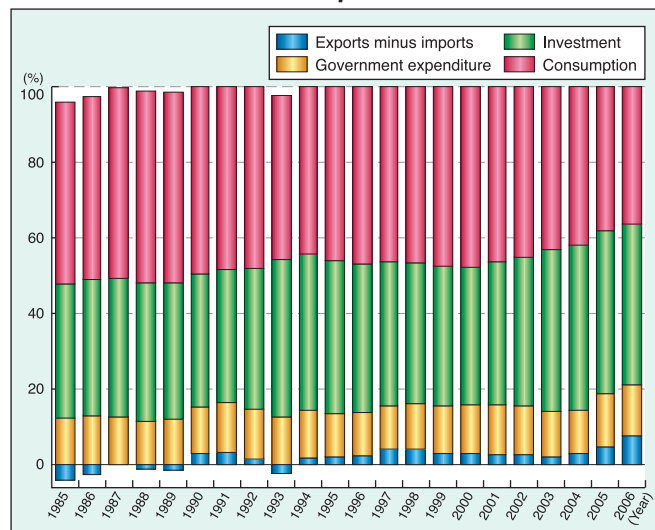
Since 2003, the investment ratio against GDP has been at 40-45% while fixed-asset investment increased 25-35% annually during the same period (*Chart*

Chart 1 Inflation rate hits high levels during the past 5 years (previous year = 100)



Source : CEIC

Chart 2 Driving forces of Chinese economic development



Source : "Key indicators 2007," Asian Development Bank

2). Although the GDP growth ratio reached 10-12%, it is still considered that investment is not efficient. As Premier Wen Jiabao noted three years ago in the National People's Congress (NPC), "Much of the investment by local governments overlaps and is inefficient, and this also increases the imbalance of external trade." Many industrial product prices are dropping even to the point of deflation, while food prices are currently inflating. Manufacturers have shifted some of the capacity from the domestic market to overseas, and as a result the external trade balance recorded a large surplus. That puts pressure to appreciate the yuan.

In fact, the external trade imbalance is not only because of trade performance and the industrial competition gap. Structurally, the domestic investment and saving balance (I-S balance) decides the external balance. For instance, in America the low savings ratio leads to a large external deficit. Conversely, China's excess savings lead to a significant trade surplus. Currently almost 55% of products are exported by companies set up in China through foreign direct investment (FDI), and 80% of high-tech products are exported by FDI companies. Domestic and local companies are therefore still facing problems of weak competitiveness and inefficiency.

If the Chinese government wants to balance external trade and soften the

pressure to appreciate the yuan, domestic investment and savings must be balanced in the first place. That is to rebuild the social safety net in order to encourage households to increase consumption. Of course it is an easy concept to understand, but very difficult to realize.

Scientific Development & a Harmonious Society

About 30 years ago, then Chinese leader Deng Xiaoping made the giant country awake and change the rail from a central-planning economy to a market-oriented economy. Deng's strategy was to gradually deregulate the government. In addition, about 15 years ago, then Premier Zhu Rongji enforced the privatization of SOEs, starting with small and medium-size and gradually shifting to larger companies.

This kind of incentive-encouraging strategy clearly improved efficiency and strengthened competitiveness. Some serious problems, however, were left over. One is that the income inequality gap has remained wide. Another is very serious environment pollution. In addition, corruption in the Communist Party damages credibility in Chinese society. All of these problems are difficult to solve because of the lack of governance, monitoring and transparency.

The Communist Party wants to main-

tain its monopoly system. Under such a system, the rule of law does not work. In China, the party and the government have the authority to judge everything, even influencing the judiciary system.

The Hu administration cannot postpone political reform, and needs to build a democratic system as soon as possible. Since 2003, the new philosophies of "Scientific development view" (Kexuefazhanguan) and "Harmonious society building" (Jianli Hexieshehui) have been propounded. The essence of these philosophies is that China should not only improve GDP growth, but also pay more attention to environmental protection and produce more efforts to bottom up the low-income bracket.

2008 is a special year for China. Through the Olympic Games, it seems likely to be the first time in the past century that global interest will be concentrated on China. Moreover, China will hold an exposition in Shanghai two years later. Many Chinese economists call it the "Golden Development Era." The issue, however, is how to sustain development and reallocate income fairly. There is still much to be done. **JS**

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