

Chinese Dragon in the Year of the Dragon

By Long KE



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The world economy remains in recession due to the debt crisis, in particular industrialized countries. The crisis shows no signs of ameliorating in the short term. There is also concern that this contagion will spread to the emerging economies, i.e., China, India, Brazil, and Russia (BRICs). Among the emerging economies, China is maintaining 9-10% real GDP growth even under such trying conditions. Even so, the international financial market is concerned whether China will be able to sustain such economic growth under the global recession.

The driving force of China's economy is in fact still very strong. First, the domestic saving ratio for households is around 30% against GDP and the national saving ratio including the government and the private sector reached 52% in 2010. This high saving ratio supports not only infrastructure such as railway networks, power plants, and airports, but also increased investment such as companies' fixed asset investments. Essentially, it is not difficult for companies to obtain financing in the domestic market, at least theoretically.

Second, China's manufacturing industry remains competitive. China has many well-educated laborers in coastal areas; this contributes to the exports by its manufacturing industry. Under the global crisis, China will find it difficult to increase its international trade surplus, but it was able to maintain trade levels at around the same level as in 2011. It was able to do this because developed countries continue to demand cheap goods and no other country can supply as good quality products at the prices China offers.

Third, there is concern that domestic private consumption is weak. Chinese policy-makers must try to solve this problem and increase private consumption as an engine to drive economic growth. However, China does have a potentially very powerful engine; it is simply a matter of how to improve household consumption.

2012 will be a very important year for China to sustain its economic growth and stabilize its society, and it will also be a difficult year as China approaches a change in administration, always a great political risk. The government therefore needs to sustain China's economic growth in order to strengthen its own administrative leadership. Furthermore, despite the many uncertainties of 2012, the government must endeavor to stabilize society.

Below, I will provide an overview of China's economy and analyze some of its social problems.

China's Economic Goals for 2012

In December 2011, the Chinese Communist Party held a central economic working conference, where party leaders decided to shift policy from macro-economic control to improvement of economic growth. In preparation for the change in administration, the government needs to maintain economic growth at a level of around 9%; the real GDP growth ratio has slowed from 10.3% in 2010 to 9.6% in the first quarter of 2011 and further to 9.2% in the third quarter. If the government does nothing to spur economic growth, the real GDP growth ratio could fall to below 9%.

In the current conditions, if the economic growth ratio were to decline to 8%, the unemployment rate would increase as a result. Official data show the unemployment rate as being only 4.2%, but the real rate is believed to be closer to 10%. The official unemployment rate is the "registered urban unemployment rate," which does not cover unregistered workers and workers in rural areas. Concerns over a rising unemployment rate would damage social stability.

The government must therefore sustain economic growth at somewhere between 8.5-9.5%. Although China will face some risks and problems, some Chinese economists believe its economy in 2012 will not be so bad. They believe that the government will enact certain policies in order to maintain economic growth. The mix of policies under consideration includes: (1) generating more liquidity for small and middle-sized companies; (2) increasing the budget for investing in infrastructure projects; (3) relaxing financial control and lowering deposit reserves; (4) increasing the minimum wage; (5) encouraging increased investment. Although the government has announced an economic growth target of 8% of real GDP growth, many think the real growth target is in fact 9%. Since the data show that China's potential economic growth is about 9%, the government's target is quite reasonable and pragmatic.

However, the problem for China is not in fact its level of GDP growth, but rather the important task of changing its economic and industrial structure in order to make the economy more efficient and "economical" instead of concentrating on simple economic

growth, which cares little for production efficiency. Over the past decades, China's economy has achieved 10% growth every year, often called the "Chinese miracle." However, this growth has depended mainly on expanding exports of labor-concentrated goods, such as toys and T-shirts. Over the past decade, the minimum wage in China has increased, especially in cities in coastal areas like Shenzhen, Dongguan, and Zhuhai. China's only improvements have been to upgrade its industrial structure in order to shift management resources from low-end manufacturing industries to high-tech and high-value service industries. Also, 2012 is the second year of China's 12th five-year plan; it must step up and change its industrial structure.

Controlling Inflation

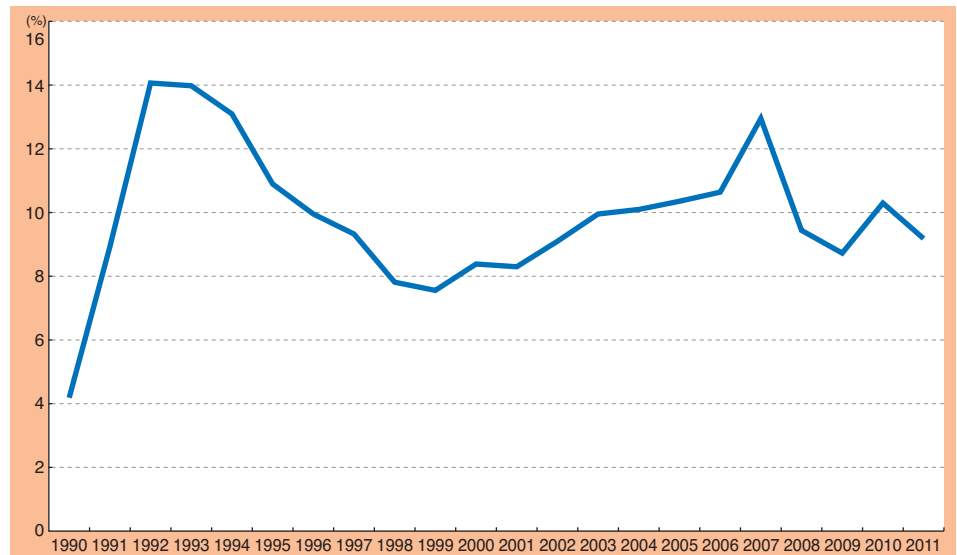
China's inflation increased in 2011 and the government enacted a policy mix in an effort to reduce it and the real estate bubble. The fact is that it is not easy for policy-makers to control market liquidity. As mentioned above, China's national saving ratio reached 52% and trillions of yuan in speculative investments flowed into the country's domestic real estate market.

On the other hand, China experienced food inflation in 2011, which is a factor that could seriously damage social stability. The food inflation was not caused by over-liquidity in the financial market, but rather by rising costs of agricultural resources and a lack of transparency in the system; the process from food producer to consumer is too long and simply serves to increase prices and consequently profits. China cannot expect that controlling financial liquidity alone will reduce inflation and bubble markets; it must also reform its distribution system as soon as possible.

China also needs to reform its financial system, which can play an important role in financial intermediation. An efficient financial system can allocate necessary resources to industries, but the current financial system is greatly lacking in efficiency. In China, all the megabanks are state-owned and generate liquidity for state-owned enterprises only. As a result, many private companies are facing difficulties because they are unable to obtain financing except in the unofficial financial market, where the interest rate is in fact illegal and several times lower than that of the formal market.

CHART

Real GDP growth ratio during global economic crisis



Source: National Bureau of Statistics of China

Why has the real estate market become a bubble market? First, I would like to stress that families purchasing residences in which to live will not lead to a bubble market. Such a market can only result from speculative activities in the real estate market.

Let us now take a closer look at the real estate market in China. Under the central planning economy there was in fact no real estate market; all land was state-owned and no one could buy or sell it. Around 20 years ago, the Chinese government announced the establishment of a market-oriented economic system and deregulated control of the market, thus allowing people to buy and sell usage rights to the land, although actual ownership of the land was retained by the state. As a result of this deregulation, both domestic and overseas investors began to speculate in this high-valued, beneficial market and it soon became overheated. Unfortunately, China's real estate market is not well-constructed. For example, the rent market is too small; it seems as if everyone wants to buy a house or apartment, which is logistically impossible.

The failure of the Chinese government to control speculation in the market is also a problem. China's taxation system does not cover private assets such as real estate, and so the more real estate one owns, the richer one will be. This system encourages the wealthy class to speculate in the market since they need pay very little in taxes. This rent-seeking behavior is the real reason behind the real estate market bubble. In order to control this bubble, China must not only enforce a new policy mix, but also reform the economic system and build a real market-oriented economic system.

Stabilizing Society

The Chinese government seems to be very concerned with social stability. Spokespersons of the incumbent party and the state-council constantly emphasize that Chinese society would go out of control if it were to adopt a Western-style democratic system. Under the Hu Jintao administration, the government strengthened its control of mass media and the Internet. President Hu Jintao himself stressed again and again the importance of building a harmonious society in China. We thereby see that Chinese political leaders are very concerned with social stability, but how does one build a harmonious society? It is clear that such a society will not be realized by the government controlling power, but rather by self-control.

Let us look at what the Hu administration has done over the past nine years to reform the political and economic systems. Nine years ago, the Chinese people expected much of Hu as a political star of the new generation and hoped that he would reform the political and economic systems and build a fair and just institution. But the political system has not been reformed; the government does not accept the governance and monitoring of the people, and consequently corruption has run rampant. Similarly, China needs to reform the economic system and create a real market-oriented system, but over the past nine years under the Hu administration this system has regressed to the central planning system. As a case in point, the state-owned enterprises protected by the government have strengthened their monopolies. The Hu administration has in fact retarded economic reform and the building of a market-oriented system.

The corruption of government officials under the Hu administration is not surprising. However, a warped political system does not contribute to building a stable society. Over the past nine years, the economy has grown approximately 10% annually, not as a result of the Hu administration's efforts, but simply as a result of China's potential economic power. Even so, the Chinese government has asked other countries, especially Europe and the US, to accept it as a market-oriented country.

It is in fact quite clear what the government must do to create a harmonious and stable society, so why does it do nothing? Despite great economic growth over the past decades, Chinese society remains unhappy in general.

Perspective of Chinese Society & Economy in 2012

According to the Chinese zodiac, 2012 is the year of the Dragon. The Dragon is a symbol of great power, and the Chinese people believe that 2012 will be a happy and prosperous year, thanks to the help of the Dragon. But in truth, a dragon is nothing more than a big snake. I don't know if a big snake can make 1.3 billion people prosperous and happy, but I do know that the people of China can become happy by their own efforts.

China's economic growth rate has slowed from 10.3% in 2010 to 9.2% in 2011. An economist inside the government commented that the economy of 2011 was not so bad, but I believe that the economy in 2012 will not be as good as expected. First, export demand will be too weak to support continued economic development. Other economic factors are chipping away at exports as well: labor costs are increasing in cities in coastal areas, and yuan appreciation is making external trade difficult. Second, unless stimulating policies are added to the policy mix, domestic demand will continue to weaken. However, the odds of the State Council adopting such a stimulating policy after the National Congress to be held at the beginning of March are very high. It therefore seems likely that the economy in 2012 will not be great, but nor will it be terrible. Hu's administration needs to make some progress in order to show results from their efforts of the past nine years.

The truth is that the biggest concern is not what will happen in 2012, but what will happen next year under a new administration. This year's greatest risk is political risk. Who will become the next chairman and who the next premier? China has no democratic election system; the former leaders will decide on the new leaders through discussions within, as if in a black box. These negotiations among different political groups to decide the new leaders are clearly not a rational or sustainable system. The only progress that can prove that the system is efficient is high-speed economic growth. The Communist Party's Central Economic Work Conference held last December decided that the trend of this year's economic policy is "to improve growth under stability." Sometimes there is a trade-off between growth and stability. For now, the government needs to reform its political and economic systems as mentioned above, and as a result of this reform the economy will grow naturally and sustainably.

Chinese society stands at a turning point, transitioning from the era of the Hu administration to the era of a new administration. This could be good news for China, as it presents an opportunity to restart economic reform and start political reform in order to build a democratic system. However, if the new leaders simply recycle old policy and refuse to reform the system, this change in administration could be bad news, since the new administration would not present strong leadership and Chinese society might become unstable.

On interviewing many Chinese people from different social classes, I found that most of them expect the government to begin reforming the political system. I believe that Hu and Wen understand the necessity of reform, as they have announced repeatedly that the government should be reformed and human rights guaranteed. It remains a mystery as to why they postpone taking on the challenge of reform. It is possible that they lack strong leadership. If so, the new leaders will need to gather the support of the people instead of playing internal political games. **JS**

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