

**China in 2006:  
An economist's view**



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*Philipp Maier*

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*Central bank and prudential supervisor financial institutions*

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# China in 2006: An economist's view

Philipp Maier<sup>1</sup>

## Abstract

Since the start of the economic transformation in 1978, China has been growing at spectacular levels. Given the size and growth of its economy, China is in a position to substantially influence world commodity prices and prices for various consumption goods. This report summarises insights from a trip to China, aimed at getting a better understanding of how the Chinese economy 'works'. Based on talks with government officials, Chinese and foreign firms, we provide evidence that (i) through piecemeal introduction of market elements, China has successfully made the transition from a planned economy to a market economy; (ii) political stability is an important factor determining the attractiveness of China for foreign investors, and (iii) regional disparities are huge, which might at some point pose a concern to further growth. Also we note that China is primarily growing through use of more inputs, not through high productivity. Looking forward, input-based growth is typically not sustainable. As productivity does not tend to grow by 10 percent annually, China's economy will probably slow down at some point. Lastly, we expect that in the medium term, real wages will rise. The resulting expansion of China's domestic market would create new export opportunities for Western firms.

Jel codes: Eo, E6o, Fo

Keywords: China, economic transition



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## I Scope of the report

The only thing growing faster than the Chinese economy is the hype about China. Over the past two decades, China's rapid growth has proved pessimists wrong, and optimists not optimistic enough. China's catching-up is not unprecedented in its scope or speed: during their period of industrialisation and integration with the global economy Japan or South Korea have grown at similar or even higher paces (Rumbaugh and Blancher 2004). But these were relatively small countries, whereas in terms of population, China is the world's largest country. The speed of the transformation triggers astonishment – and sometimes fear: March 2006 the two best-selling books about the Chinese economy at Amazon.com are 'China, Inc.: How the rise of the next superpower challenges America and the world' by Ted Fishman and Constantine Menges' book 'China: The gathering threat'. This illustrates the mixed feelings some express about China.

Given the size and growth of its economy, China is a position to substantially influence world commodity prices or – through its exports – prices for consumption goods like textiles or electronic products. Hence, China can have a considerable impact on inflation developments in its main trading partners. This warrants that central banks closely monitor the Chinese developments. Analysis of China's economy is complicated by uncertainty about the quality of its statistical data. In addition, the opaque political system may hide the true extent to which the government is actively interfering in the economy. Against this backdrop a visit to China was conducted, aiming at getting a better understanding of the Chinese economy. This report summarises the information and provides insights into how the Chinese economy 'works'. We also discuss major challenges for Chinese policymakers. We do not cover all aspects of China's transition; instead, we focus on selected institutions or economic sectors.<sup>2</sup>

We visited Beijing, Shanghai and Xi'an (including its surrounding rural areas). Interviews were arranged with representatives of the following institutions or firms:<sup>3</sup>

- The People's Bank of China, the Ministry of Commerce, the National Development and Reform Commission and the Shaanxi Provincial Development and Reform Commission;
- All-China Federation of Trade Unions;
- abn Amro Shanghai and the Shanghai Pudong Development Bank;

- The carmakers byd and Shanghai Volkswagen;
- Professors from the Chinese Academy of Science, Beijing, and the Economics Department, University of Xi'an.

We proceed as follows: the next section provides a brief description of the Chinese economy in 2005/2006. Section 3 describes a number of selected issues in more detail. Section 4 assesses where China is heading. Section 5 summarises our main findings.

## 2 The Chinese economy

### 2.1 Some stylised facts

Looking back on China's post-ww ii economy, we can broadly distinguish the period before and after 1979: until 1979, the country was a centrally-planned economy, leaving people only very limited economic freedom. In 1979 the transition towards a more market-oriented system started.<sup>4</sup> It originated in the agricultural sector, when farmers were given possibilities to sell output exceeding production quotas on local markets. Since then, market-based economic principles have spread to other economic sectors. Large welfare gains have materialised in cities, most notably in the Coastal Provinces, where introduction of 'Special Economic Zones' – zones in which foreign investment could receive special treatment – ignited the transformation process.

At the aggregate level, the result of the economic reforms has been spectacular: over the period 1979-2005, China's average growth rate was 9.5 percent; over the last decade, growth accelerated even further to 9.9 percent (see table 1 for selected economic indicators). This means that China's gdp has doubled roughly every eight years. While most economies in the world would build up increasing inflationary pressures when expanding at such speed, China reports inflation figures safely below 5 percent. At the same time, public debt is low (below 25 percent of gdp).<sup>5</sup> But the success story is not without risks: current weaknesses include the high investment rate, leading to overinvestment in sectors like steel, aluminium and automobile production (in some sectors investment grows by almost 100 percent annually). This overheating is not sustainable. It also creates severe strains on the consumption of natural resources. Visitors to large cities cannot help to notice that pollution is becoming a major problem, as 8 of the world's 10 most polluted cities are found in China. To address environmental concerns Chinese authorities strive to slow down the investment rate from ca. 40 percent of gdp to around 25 percent over the longer term.

At the present time the economy is highly dependent on exports. This has raised concerns in the u.s., notably because the share of manufactured goods in Chinese exports is very high. The producers of these goods are primarily overseas companies (around 30 percent are from the u.s.), and the Chinese are keen to point out that the bulk of the economic gains occur outside the country.<sup>6</sup> Future policies will be

**Table 1 Selected information on China**

	1975- 1979	1980- 1984	1985- 1989	1990- 1994	1995- 1999	2000- 2004
Real gdp growth (per capita)(%)	4.86	7.64	8.73	9.29	7.67	9.70
Inflation (%)	1.10	2.74	8.94	9.12	10.30	0.88
Total population (millions)	943	1,009	1,084	1,164	1,230	1,280
Unemployment (%)	5.35	3.22	2.08	2.50	3.04	3.84
Government debt <sup>1</sup>	-	-	-	53.88	123.40	399.15
Investment /gdp (%)	-	-	-	48	37	40
Current account surplus row <sup>1</sup>	-	15.07	-16.98	10.69	19.74	36.61
China's imports from the row <sup>1</sup>	-	73,054	131,285	153,988	166,458	307,104
China's export to the row <sup>1</sup>	-	88,713	145,364	252,704	292,498	530,185

Source: imf and World Bank.

row: rest of the world.

<sup>1</sup> Billions of usd (constant 2000 values).

aimed to change the export mix and to move up the value chain. Also policies are geared towards shifting the export-driven economy to a domestically-driven economy by raising real income, most notably for low-income groups.

China's large population continues to pose difficulties, and the creation of jobs remains the overriding objective. At present about 10 million jobs are created every year. Sustaining the high pace of job creation is getting difficult: in the 1990s, for instance, 1 percentage point of extra growth resulted in jobs for about 1.3 million people. The same increase in growth nowadays only creates extra jobs for about 800,000 people. Against this backdrop, the Chinese authorities aim to develop labour-intensive industries, notably in the service sector.

## 2.2 A (simplified) description of the Chinese economy in 2005/2006

Figure 1 gives a stylised overview of the Chinese economy. The supply side is given by the right part of the diagram: the Chinese economy is characterized by an abundant supply of labour (1). This has two direct effects:

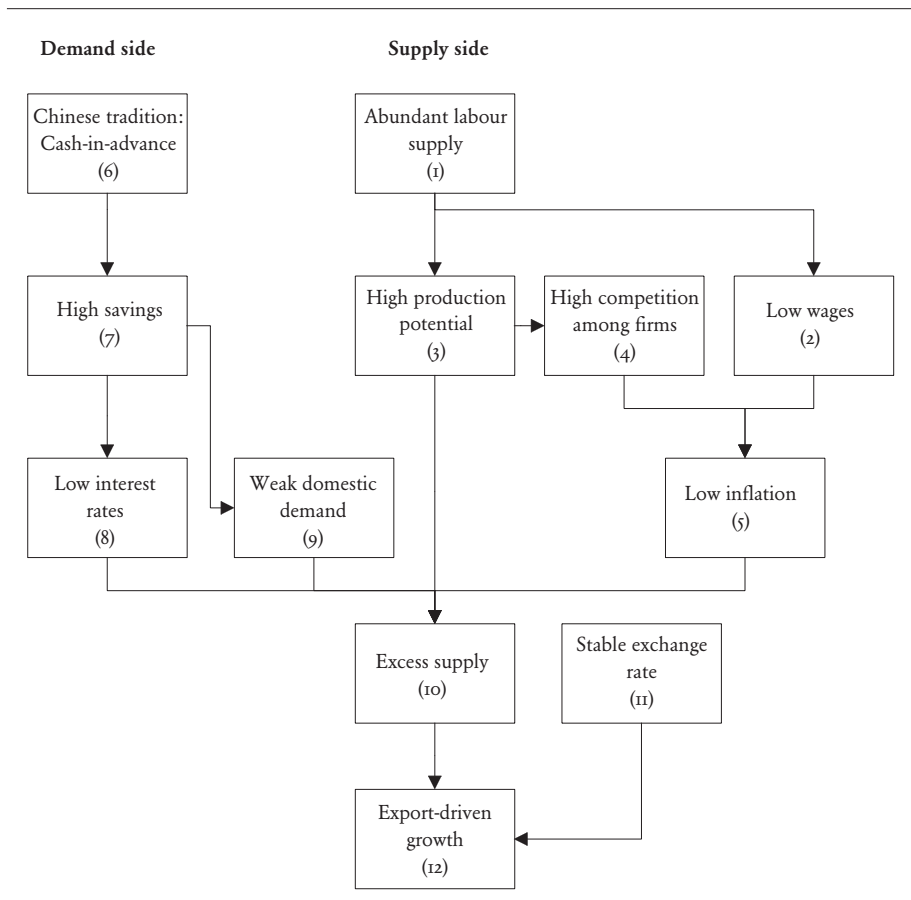
- First, a large labour supply keeps the relative price of labour very low (2). Although wages have risen somewhat over the past years,<sup>7</sup> migration of cheap labour from the rural areas puts a lid on inflationary pressures from rising wages.
- Second, the Chinese production capacity is (potentially) very high (3). This holds even though at the present stage, capital may still be insufficient to realise the economy's full production potential.

Partly as a result of that, but also because China features many fast-growing, small and medium-sized firms, competition among Chinese firms is tough (4). For

instance, 27 out of 31 Chinese provinces produce cars.<sup>8</sup> The combination of high competition, large production potential, and cheap labour keeps inflation at low levels (5) – certainly for an economy growing at almost 10 percent. Interviews suggested that e.g. prices for food or clothes have fallen in recent years.

Regarding the demand side, at first sight the high Chinese savings rate is a puzzle. It would seem that in an environment of very low (if not negative) real interest rates and high gdp growth, consumption smoothing would entail high borrowing rather than high domestic savings. Factors contributing to the Chinese reluctance to spend money are the ever-changing economic environment (e.g. recent reforms of the health care system and the education system require huge private savings), the lack of an efficient network of social security, and uncertainty about the pension system. To some extent, lack of credit and investment opportunities may also play a role. In addition, out of tradition, the Chinese do not like to be in debt, even though younger generations seem to be somewhat more inclined to buy e.g.

**Figure 1 The Chinese economy in 2006**



houses or cars on credit. Taking these factors together imply that China operates like an economy with a huge 'cash-in-advance' constraint (6). As purchases are not financed by credit, savings are high (7). The high savings rate has two effects: on the one hand, Chinese interest rates are relatively low (8); on the other, domestic consumption is very weak (9).

The combination of low interest rates,<sup>9</sup> weak domestic demand, a high production potential and low inflation results in supply outstripping demand in China (10). Given China's excess supply capacity, and helped by the stable – and possibly undervalued – exchange rate (11), China's export industry is booming (12). China has ended up with an export basket that is significantly more sophisticated than what would be normally expected for a country at its income level (Rodrik 2006). This has been an important pillar supporting China's rapid growth. Over the medium term, a situation is likely to be reached where domestic consumption will pick up. This could happen via rising real wages, or via an appreciation of the Chinese exchange rate (which in turn would raise real incomes and boost private consumption). From this point on, China will have to rely less on its export performance to grow.

## 3 Selected economic issues

### 3.1 Central banking and financial supervision

China's main financial authorities are the People's Bank of China (pbc) and the China Banking Regulatory Commission (cbrc). The pbc has the dual objective of promoting growth and keeping inflation low. Unlike central banks in most advanced countries, the pbc is not independent: when setting monetary policy the pbc makes a proposal to the Vice Premier and the State Council. The views of the pbc and the State Council need not coincide, and given China's desire to create jobs, the State Council probably puts more emphasis on growth than on low inflation.

The pbc conducts open-market operations with domestic and foreign banks. In this two-tier banking system the interbank interest rate is increasingly market-determined. In conducting monetary policy, the pbc is constrained by the fixed, undervalued exchange rate. Due to inflows of 'hot money', money growth is currently above the 14 percent target for 2006. Given that, it is very likely that this year's inflation rate will exceed the envisaged 2-3 percent. In addition, large capital inflows bear the risk of creating speculative bubbles, e.g. in the real estate sector. Recognising this danger, the pbc has set up a special division to monitor real estate prices.

pbc staff is recruited from the Chinese population. Higher management is increasingly foreign educated (attending a u.s. university is encouraged). Also senior pbc staff has the opportunity to go abroad and gain expertise through work for e.g. the imf or the World Bank. In addition, to gain foreign expertise a Visiting Scholar program has recently been introduced.

In 2001, the (relatively) independent cbrc was created to supervise financial institutions. Banks report that by and large Chinese regulators seek to adopt best-practices, e.g. by ensuring that accountability for credit allocation within a commercial bank is clearly defined. In practice, however, due to lack of expertise, implementation and execution of modern risk-management systems can be complicated (which is why new scandals involving embezzlement of funds by regional bank managers are unravelled on a regular basis). In other words: regarding banking supervision the direction of the policies is right, but the monitoring is still insufficient.

### 3.2 The financial sector

Reforms of the banking industry are changing the financial landscape dramatically: Until 1979, the People's Bank of China was the only bank. Its domestic business involved lending to state-owned enterprises, so the banking industry faced virtually no risk. Risk management systems did not exist. Since 1979, Agricultural Bank of China, Bank of China and China Construction Bank began to function as specialized banks, and in 1984, Industrial and Commercial Bank of China was established. Since 1994, these four banks became wholly state-owned commercial banks, with the People's Bank of China as (sole) central bank. In addition, several thousand small banks exist, most of which are credit-cooperatives operating in less-developed areas.

As China began to liberalise its economy, banks were suddenly exposed to credit risk and market risk (interest rate risk and exchange rate risk). As the exchange and interest rate are not fully liberalised yet, current risk evaluation benchmarks are still not fully developed. Also markets for options and derivatives need to be developed.<sup>10</sup> Lack of expert knowledge and, to some extent, lack of modern IT infrastructure are among the problems Chinese banks are facing when dealing with risks. To acquire expertise, three of the four large banks now have foreign investors.

Government intervention in loan provision in the four large banks is rapidly falling, as credit allocation is increasingly based on risk-return considerations. One sign of the improvements in the financial sector is that the share of non-performing loans is falling rapidly, as banks are less and less required to lend to loss-making state-owned enterprises.<sup>11</sup> Also the regulatory framework is rapidly transforming (abn amro reported that a 'major' regulatory change substantially affecting business strategies occurs almost every week). For instance, banks were only recently allowed to introduce fee-based services (e.g. for wealth management). When foreign banks entered the Chinese market and started to charge fees for overdraft etc. a public outcry ensued, as people were simply not used to paying fees.<sup>12</sup> In addition, a major problem banks are facing is insufficient protection of their business through the legal system.

Very different problems persist in the rural area. Typical rural financial institutions are 'microbanks' or credit-cooperatives, which have a small loans program to enable purchases of e.g. seeds or fertilizer. On the one hand, the experience with these programs is very good, as e.g. the rate of non-performing loans is very low. On the other hand, local authorities tend to intervene in the operation of local banks: as local authorities distribute basic inputs like electricity or water, they have some leverage to interfere with bank operations. Also, supervision of these banks is poor, as the supervisory body concentrates on the big four. The speed of catching-up of poor Chinese provinces has found to be correlated with the quality of local financial markets. This underlines the importance to improving the rural banking industry.



**Foreign banks: The example of ABN AMRO**

*The Chinese financial market is increasingly penetrated by foreign banks. One example is ABN AMRO, a Dutch bank operating in China. Within China, its strategy is to concentrate on private enterprises, as they are growing very fast and are typically well managed (though that is improving rapidly in state-owned enterprises, too). In addition, private firms find it much harder to raise capital than state-owned enterprises, so they are better accessible as clients. Note also that Chinese clients are very loyal, and it is possible to sell them a broad range of products. Given the difficulties to assess a client's riskiness, ABN AMRO is not 'chasing' every client. One of the advantages ABN AMRO has compared to Chinese banks is its international network. As a result, about 70 percent of its clients are from abroad.*

### 3.3 Exchange rate matters

China's exchange rate policy has triggered considerable controversy. For more than a decade, China has effectively pegged its currency to the u.s. dollar. Huge current account surpluses indicate that some degree of undervaluation is likely (for an overview of studies see Dunaway and Li 2005). In 2005 and 2006, cautious steps towards more flexibility have been undertaken; yet they have not resulted in a marked appreciation. To correct this imbalance (and to boost China's national income), many have suggested that China should let the Renminbi (rmb) appreciate against the u.s. dollar (e.g. Blanchard and Giavazzi 2005). From the perspective of Chinese policymakers, there are three reasons to keep the u.s./rmb exchange rate stable.

- Inability of financial institutions to cope with exchange rate risk (see also Prasad et al. 2005): This is amplified by the possibility that export-oriented firms might suffer if the exchange rate appreciates. Whether firms hedge exchange rate risk at all is unclear.
- Reliance on export-driven growth: A stronger Chinese currency drives up prices for exports goods. That said, given China's cost advantage relative to virtually all oecd countries, exports in many sectors are not thought to be very sensitive to changes in the exchange rate.<sup>13</sup>
- The agricultural sector: A higher rmb exchange rate might trigger additional food imports, squeezing farmers' incomes. Given that farmers' incomes are relatively low and hence the rural areas are relatively poor, the Chinese authorities do not seem willing to take this risk.

In particular the last reason seems to be paramount in explaining policymakers' reservations about exchange rate flexibility. Keeping its exchange rate stable, China is running three major risks: first, accumulation of foreign reserves inflates money growth. Second, the larger the stockpile of foreign reserves, the larger potential valuation losses, should the Renminbi appreciate in the future. Third, firms might rely overly on stable exchange rates when evaluating a project's return, and might not take sufficient precautions against exchange rate risk. It is unclear how the Chinese

authorities deal with these risks.<sup>14</sup> An appreciation would also help shifting demand away from exports to domestic consumption, which is one of the goals of Chinese economic policy.

During the interviews, various sources indicated that China has avoided a big bang approach in its transition (unlike most other transition countries). The piecemeal introduction of reforms has worked in most areas, so it is speculated that the Chinese authorities are likely to follow a very similar approach when it comes to exchange rate issues. Also, it was pointed out that Chinese firms are not yet prepared to deal with flexible exchange rates. Full liberalisation of the exchange rate may therefore take time.

### **3.4 Trade Unions and the labour market**

The All-China Federation of Trade Unions (acftu) has about 115 million members. This may sound like a large number, but given that China's labour force exceeds 800 million workers, the power of Chinese trade union is relatively limited. The acftu's mission is to safeguard workers' rights, which comprises wage negotiations, avoiding late payment of wages (about 4 to 7 million wages are paid late), health regulation etc. Chinese trade unions play an active role in both state and enterprise affairs: on the one hand, they meet with the government on a regular basis and help to shape legislation concerning workers' rights. On the other hand, trade unions seek to mediate at firms, should disputes between workers and management arise.

Overall, the Chinese labour market is extremely flexible: China's wage bargaining system is highly decentralized, as wages are decided upon in firms (though partly supervised by the government). Trade unions promote wage bargaining at the firm level, seeking detailed regulations in a collective agreement. Since 1990s almost 400,000 private enterprises have adopted collective wage bargaining systems. During the interview, the Chairman of the acftu expressed discomfort about raising inequality; yet the organisation sees no alternative to policies fostering economic growth as a tool to raise workers' living standards. In interviews with firm managers no single contact expressed dissatisfaction about possibilities to recruit or to dismiss workers. Also wage inflation was not seen as a major issue for the coming years, as the supply of labour is still very high.

### **3.5 Migration and inequality**

By some accounts over half of the reduction in absolute poverty in the world between 1980 and 2000 occurred in China (oecd 2005). This masks rising disparities between cities and the rural areas: Average farmers' per capita income reached 2,936 rmb (us \$ 353.7) in 2004, whilst that of urban residents was 9,422 rmb (us \$ 1,135).<sup>15</sup> In recent years productivity gains in rural areas have stalled: farmers are not allowed

to own land, they can only rent it for up to 70 years. More land can only be acquired by sub-renting land from e.g. farmers that have migrated to cities. Given the limitations to increase farm size, agricultural production lacks economies of scale. Also farmers lack securities to back loans, so possibilities to invest in machinery are limited.<sup>16</sup>

To address regional disparities Chinese leaders are planning to move some 300 to 400 million peasants from the countryside to the cities by 2020. They hope to complete this process – which took western developed countries three to four hundred years – in less than 20 years. The government wants to increase the urbanisation rate from 42 percent to 75 percent by the middle of the century.<sup>17</sup> Chinese experts estimate that just in the past decade large cities in the country like Beijing, Shanghai and Shenzhen have expanded at an average rate of ten percent annually. About 120 million migrant workers currently work and live in China's large cities; and every year more than 10 million farmers move from the agricultural sector to other sectors. Most of the 'migrant workers' have very limited legal rights and low income.

### **Example: Regional disparities**

*The table below gives an indication how large regional disparities are: Xi'an is the capital of Shaanxi province, one of China's poorer regions. Average industry wages in Xi'an are between a third and a fifth of those in Shanghai. Migrant workers in Xi'an earn even less, their salaries are about 500-600 RMB per month – if they can find work. Social security payments effectively put a minimum floor on wages in cities (though not for farmers), but note that e.g. in restaurant business (which hardly pays more than minimum wages in many industrialised countries) typical wages are about twice as high as the minimum wage. This shows that minimum wages are not really a binding constraint. The disparity in living costs is striking, most notably in house prices.*

	Rural village	Xi' an	Shanghai
Average industry wage	800 RMB	1,000 RMB	3,000-5,000 RMB
'Minimum wage'	-	350 RMB	500 RMB
House price per m <sup>2</sup>	1,500 RMB	2,500 RMB	10,000-20,000 RMB
Price for 1kg potatoes	1 RMB	1 RMB	4 RMB

*The following example might provide an indication of how low wages really are: In a Chinese 'Starbucks-style' coffeehouse the smallest, cheapest coffee is about 12 RMB. Hourly wages in the same coffeehouse are about 3 rmb, i.e. after four hours of work waitresses have earned enough to buy the smallest, cheapest coffee. A more 'sophisticated' product like a small cappuccino is about 20 RMB.*

Looking ahead, reforms targeted to make the agricultural sector more efficient – e.g.

by allowing farmers to buy land– will expand average farms’ sizes. Also increased use of machinery will reduce employment opportunities in the countryside. This could trigger additional migration flows. Even today migrant workers can be found in every major city. When a car stops at a railway station, migrant workers come running, hoping for work. In interviews they indicate that temporary work will earn them about half of the average monthly wage of a regular worker. Having little to no skills, they will essentially take any job offered to them; mostly in the construction sector.

**Example: Living in the countryside**

*We drove to Fang Jia Zhai, a small village about 20 minutes outside Xi’an. Lack of machinery in the agricultural sector is striking, e.g. we saw Chinese farmers using an ox to plough the earth. The home of my guide was built by his father (back then the Village Chief) in 1974. Like in most Chinese rural villages, houses in Fang Jia Zhai, do not have running water or a sewage system. Lacking heating, the house has a bed made from clay, which can be warmed by lightening wood in a hole underneath the bed. That said, although the differences between rural areas and cities are striking, there is progress: for instance, pensions for workers have increased substantially.<sup>18</sup> A local shop-owner expressed confidence about the economy, noting that e.g. the number of shops in the village had increased from 2 to 8 over the past years, as more and more villagers find work in a nearby ‘Technology development zone’. Industrial average wages for skilled workers are around 800 RMB/month in a nearby village, which is somewhat lower than the 1000 RMB earned in Xi’an. The downside of this development is that house prices have increased sharply over the past years.*

The Chinese authorities take a somewhat ambiguous approach regarding migration. On the one hand, they encourage farmers to migrate to cities, as this is where the country’s economy is developing most rapidly. On the other hand, various measures are in place to restrict migration, e.g. one needs a job and a house to be able to register in Shanghai. To build ‘modern rural areas’ the government has decided that additional funds will be given to China’s rural areas to improve education and medical care. In addition, taxes on farmers were abolished in 2006,<sup>19</sup> and measures are taken to build industries and improve the rural financial sector.

### 3.6 The automobile industry

Given the importance of the automobile industry in many advanced economies, we visited factories of byd (a Chinese carmaker in Xi’an) and Shanghai vw (a German-Chinese joint venture). Generally speaking, the differences between the two companies could hardly be greater: car production at Shanghai vw is capital intensive. To produce premium cars, whose quality matches high European standards, workers are using Western machinery. byd focuses on the lower segments of the Chinese market. In its assembly hall cars are literally assembled by hand (the only piece of ‘machinery’ is a screwdriver).

Most of China's car industry are presently aimed at the lower end of the market. As manual labour is very cheap, their relatively simple cars can be produced at very low costs (note that use of machinery in car manufacturing in advanced countries is not only a consequence of high labour costs, but they are also needed to keep quality high). It is only a matter of time before Chinese manufacturers will start exporting their cars to Europe and North-America. Producers of lower-end cars are likely to be the first to experience Chinese competition in their segment. Against this backdrop the strategies of various European manufacturers to position themselves as 'Premium brand' are understandable.

**Example: BYD versus Shanghai VW**

*BYD ([www.byd.com.cn](http://www.byd.com.cn)) is a Chinese conglomerate, originally specialising in production and assembly of cell phones. As BYD has experienced very fast growth in its IT business, the company decided to diversify and started to producing car parts and, finally, cars. BYD has various car plants in China. In Xi'an the company assembles 200 cars per day, mostly for the Chinese market (although they are in talks with distributors in the United States and Europe to export their cars). The choice for Xi'an was motivated by its convenient location in China's centre and its good transportation network. Also salaries in Xi'an are lower than in Shanghai, where more skill-intensive work like R&D is done. Recruitment of new workers does not pose problems (in just one year the number of workers in car assembly doubled), and for the coming years wage inflation is not viewed a serious issue. For the automobile production BYD does not import any inputs from outside China. Government does not interfere in the company's business decisions.*

*Shanghai vw ([www.csvw.com](http://www.csvw.com)) was founded in 1995. Since then, more than three million cars have been produced, mostly for the Chinese market (only about 1000-2000 cars were exported). Development is increasingly done in China, as knowledge of the local market is required to produce cars that sell. Facing a falling market share, Shanghai vw has increased the speed at which new cars are introduced. The localisation rate – a measure for the use of local inputs – of old models was about 98 percent, for new models the rate is between 60 and 70 percent (projected to increase, though, as more and more local suppliers are involved to build up local knowledge). Shanghai vw is paying fees to the vw parent for technological transfer. In the last 2 years pressure from low-cost competitors has been felt, as buyers have difficulties distinguishing cars of different quality: many customers are first-time car buyers and have never experienced the difference between a 'good' and a 'bad' car. Hence, the relatively expensive vw's are difficult to sell and Shanghai vw has to educate the public by explaining basic concepts like a car's safety features.*

### 3.7 Corruption

Foreign media regularly report about Chinese corruption scandals. Here is an example:

'Various indicators... suggest endemic graft within the state. The number of 'large-sum cases' (involving monetary amounts greater than \$6,000) nearly dou-

bled between 1992 and 2002... the number of officials at the county level and above prosecuted by the government rose from 1386 in 1992 to 2925 in 2002' (Pei 2006).

Reports about corruption or misappropriation of funds are also found in Chinese newspapers. Against this backdrop we interviewed a person employed in the 'Internal audit' Department of the Shaanxi Provincial Reform and Development Commission. In his view, anti-corruption policies are increasingly following best-practices, although monitoring and executing them is still a challenge (his department consists of 3 people, supervising about 200 persons). Generally speaking, corruption is most widespread in the construction sector. Recognising this issue, decisions are increasingly taken by committees (which are thought to be more difficult to bribe than individuals). Also large projects need to be approved by more than one governmental body.

'Whistleblowers' schemes are in place to report corrupt bureaucrats; yet given the country's poor legal system, it is not always clear whether corrupt officials will actually be convicted. That said, to the extent that Senior Officials are members of the Communist party, they must also adhere to the party's 'Code of Conduct'. Accusations of leading an 'inappropriate personal lifestyle' are regarded as a violation of this code, which can result in losing one's job. This gives corruption fighters a potentially powerful tool to expose higher-ranking, corrupt bureaucrats.

## 4 Where is China heading?

### 4.1 Why is China growing so fast?

In principle, an economy can be growing from two main sources: growth through more inputs, or growth through productivity.

- For a given production technology, more inputs means more output.
- For a given amount of inputs, higher productivity implies more output.

The literature is divided about the source of China's growth: while e.g. Krugman (1994) is emphasising the role of inputs, other studies yield more favourable estimates of productivity growth (see e.g. Chow and Lin 2002, Wang and Yao 2003).

In our view, Chinese policymakers are primarily interested in creating jobs. This supports the view that China is currently growing primarily by using more inputs, rather than through total productivity. Clearly, as farmers move from agriculture to manufacturing, their productivity increases, but raising productivity is not an important objective of Chinese economic policy (i.e. they do not have a 'Lisbon agenda' with specific measures targeted at improving productivity). This is because productivity growth potentially hurts employment. In fact, use of labour for activities like cleaning highways raises doubts about the efficiency of the Chinese economy.

Looking ahead, countries growing through mobilisation of inputs are bound to experience decreasing returns. At some point it will become increasingly expensive to mobilise extra inputs, as the quality of new workers will decline. This implies that at some point the source of China's growth will have to shift and China will have to grow through higher productivity. As productivity typically does not grow at 10 percent annually, China's growth performance is likely to slow down. That said, given the size of the Chinese labour pool, e.g. Eichengreen (2004) has estimated that it might still take another 10-20 years before that point will be reached.

### 4.2 What next?

China's integration into the world economy can be viewed as a positive labour supply shock. In a perfectly flexible world, the price of labour would fall in all countries, as world labour supply increases. In the real world, the impact outside China is likely to be more muted, as e.g. barriers to migration exist. Trade in goods

and service can partly substitute for migration, and arguably this is what happens: as China exports cheap goods, the bargaining power of workers in wage negotiations is eroding (although in practice, the impact is hard to measure, see Freeman 1995). Also inflationary pressures in Western economies remain contained (Kamin et al. 2004).

Over time, the most likely economic scenario entails that Chinese real wages will rise (either through wage inflation or through an appreciation of the Chinese exchange rate). This implies that the Chinese domestic market will expand, creating new export opportunities for Western firms. That said, this scenario assumes that China's ongoing transition will not suffer from major external shocks or economic policy mistakes.<sup>20</sup> A number of weaknesses are apparent:

- Although state interventions in China's increasingly market-based economy are rapidly falling, local and central government bodies still play important roles in transforming the economy. Good decisions require sound knowledge and good data. Both are lacking in China, as the quality of the statistics is poor and the policymakers seem to assume that delegating decisions to councils of 'experts' automatically leads to good results (despite being far from clear what qualifies someone as an 'expert').

- China's financial sector remains a concern. As outlined above, the pace of reforms is high, and most reforms are believed to be going in the right direction. At the same time, it has been noted that Chinese banks' balance sheets are still relatively weak.

- Generally speaking, there seems to be a lack of modern economic theory. For instance, the lack of insight into exchange rate issues of most contacts at the National or Provincial Reform and Development Commissions or China's central bank is surprising.

- The fixed exchange rate fuels capital inflows, which in turn lead to high credit growth. In combination with the very uneven distribution of economic growth it is very hard to avoid emergence of sectoral or regional economic bubbles, as e.g. monetary policy instruments are not suitable to address regional disparities. Here a major concern is the housing market.<sup>21</sup> Central planning of the economy could in theory help to ensure regionally balanced growth. However, in practice the incentives of local and central policymakers are not always aligned, as lower levels of government are motivated to generate high levels of growth. This could imply that policymakers in large cities do not take necessary steps to slow down economic activity in vulnerable sectors, or to channel investment funds into the most productive uses.

- A related issue is lack of income growth in rural areas. Large-scale infrastructure projects like highway construction aim at reducing regional disparities, but as of yet, farmers have clearly benefited to a much lesser extent from the ongoing transformation. It is in agriculture where the largest remaining traces of Communism are still found – e.g. apparent by the fact that farmers may still not own land. This



clearly hampers their economic prospects. Assigning property rights to farmers may be politically very sensitive, as it touches one of the 'core principles' of Communism. Nevertheless, it would seem to be one of the most promising ways to make the agricultural sector more competitive and to generate sustainable income growth in the rural areas.

– Huge disparities in income could endanger China's stability. As of yet, a key advantage of China is its political stability: no other country in the world offers this combination of high growth and low political risk. This is one of the reasons why China is so attractive to foreign investors. During the interviews most Chinese expressed a high degree of trust in the government, and it was repeatedly stressed that Chinese authorities have delivered on past promises.<sup>22</sup> So most Chinese expect that their situation will improve in the coming years. Deng Xiaoping reportedly coined the motto 'Everyone will get rich, but let some get rich first.' Should the Chinese economy fail to produce 'riches for everyone', e.g. because of adverse shocks, faith in the government may rapidly erode. In the face of economic setbacks, it takes very little to imagine a situation in which frustration of a vast pool of unskilled workers with limited prospects to find jobs turns against the country's rigid political system.

Easterly (2002) emphasises political factors as one of the key determinants of long-term growth. We believe that this will ultimately determine China's economic future. How the Chinese leaders would handle a situation in which the Chinese demand changes to the political culture – and whether they can retain their firm grip on the Chinese society – remains to be seen.

## 5 Conclusion

What once was a sluggish, planned economy has been transformed into a vibrant market-based economy. How large the scope for economic gains from transformation was became apparent once the reform process started. Carefully experimenting with reforms on small scales, China was able to avoid mistakes (later) made by many other transition countries. The piecemeal introduction of reforms in combination with a stable political system turned out to be the key to huge increases in welfare. In the introduction we mentioned that the two best-selling books about China highlight the threat the country may pose to advanced economies. It might be worth recalling the debate about Japan before the country fell into economic crisis: Popular books praising Japan's success formula published before 1985 carried titles like 'Miracle by design' (Frank Gibney), 'Why has Japan succeeded?' (Michio Morishima) or 'Japan as Number One: Lessons for America' (Ezra F. Vogel). After more than 10 years of dismal performance of the Japanese economy, the market for these volumes seems rather limited these days.

Will the same happen to China? Will China's economy really surpass Japan's by 2020 and the u.s. by 2050, as Goldman Sachs (2003) predicts? One the one hand, China possesses many 'ingredients' to continue growing: China's population is huge, and the gains from transformation are certainly not exhausted yet (most notably in the agricultural sector it is not difficult to envisage improvement). China's huge domestic market is an important asset, and it is somewhat ironic that the Chinese – who are arguably among the most entrepreneurial people in the world – were trapped in an inherently inefficient, Communistic economic system for many years.

But on the other hand, major challenges persist, most notably inequality: we can hardly imagine a stable economic and political landscape, consisting of a relatively small minority of wealthy people and a large pool of poor, unskilled workers. In our view, in the long run a market-oriented economy cannot exist without some basic democratic rights. Having shown extraordinary abilities to generate economic growth, it will be interesting to see whether China's economic transition will at some point also induce a political transition.

## Notes

1 Bank of Canada, International Department, Ottawa, Canada. Email: pmaier@bankofcanada.ca. This study was partly written during a stay as Visiting Scholar at De Nederlandsche Bank. Funding and help was provided by the Atlantic-Pacific Exchange Program, Rotterdam, and De Nederlandsche Bank. The views expressed are the author's and need not reflect those of the institutions mentioned above.

2 The information provided during the interviews need not be representative for the entire Chinese economy. That said, huge similarities emerged during the interviews, which is why we are confident that the picture provided is fairly accurate.

3 To enable an open exchange of views, the contact persons' names are not mentioned. Details are available upon request. In addition information stems from talks with (randomly selected) migrant workers, farmers, small shop owners, taxi drivers, restaurant managers etc.

4 Deng Xiaoping's re-ascent to power and the start of political, economic, social, and cultural reforms at the Eleventh National Party Congress in December 1978 is a major turning point in modern Chinese political history. The classic party line calling for protracted class struggle was exchanged for one in which the success or failure of policies is measured by attainment of economic goals. In other words: economics, not politics, is in command ever since (for more information see e.g. <http://www.nationsencyclopedia.com/>).

5 During the transformation process, China has encountered various setbacks. One of the most recent is the outbreak of sars in 2003. As no country had ever experienced sars before, uncertainty about its long-term effects (thought to be between 1-3 years) prevailed. It took about half a year to control sars.

6 An often-cited example is production of a Barbie doll: it sells for roughly \$20 in the u.s., of which Chinese producers earn only 30 cents.

7 Reports from some regions in China indicate that – in particular in the coast regions – labour supply is less 'inexhaustible' than previously thought: Turnover in some low-tech industries is high, and e.g. Guangdong Province reports having 2.5 million jobs unfilled (see 'How rising wages are changing the game in China', *BusinessWeek Online*, March 27, 2006). *abn amro* reported that three candidates they considered for a position had attracted a total of 6 headhunters.

8 Some Western firms face difficulties in China because the competitive environment is very 'unusual': e.g. the paint industry in most industrialised countries is dominated by 5-10 major players. In China, paint producers face about 6.000 (!) competitors.

9 As China is growing at close to 10 percent a year, it may seem surprising that China's real interest rates

are so low. An important factor determining the natural rate of interest – which in a steady-state growth environment (and in the absence of a risk premium etc.) equals the real rate of return – is productivity. Estimates of productivity developments are notoriously unreliable, but given that Chinese authorities aim at high employment, rather than high productivity growth, it may not be unreasonable to attribute the relatively low interest rates at least in part to the poor productivity performance.

10 Note that a country's financial system is not independent of the stage of development of its economy. China's income per capita is still very low, which is one of the factors explaining the lack of modern banking tools. See also Garcia-Herrero (2005)

11 In the late 1990s the *pbc* put the *npl* ratio of the entire banking system at around 15 percent (*Asiaweek*, December 5, 1997). As an indication of the improvements, Shanghai Pudong Development Bank nowadays has a *npl* ratio of 1.88 percent and a provision rate of 144 percent (in fact, the bank's international auditors recommended rather lowering than increasing the provision ratio).

12 One aspects of the transition for Chinese banks is to rely less on spreads to make profits, but to charge fees. – A different example for a regulatory change the following. Previous regulation stipulated that every branch of a foreign bank had to meet separate capital requirements. Consequently, no foreign bank was willing to set up a branch network. This policy was reversed, such that now headquarters can provide capital for the entire branch network. Such changes, as well as introduction of derivative products or changes to the exchange rate system, are introduced without prior consulting.

13 Note also that wages in many export industries are even lower than those in domestic firms, as local governments issue favourable wage contracts to attract *fdi*.

14 *pbc* staff reported that their major source on Chinese reserve accumulation was the website of the u.s. Treasury. This underlines the poor communication among Chinese governmental bodies.

15 Source: *China Daily*, April 14, 2005. The official view holds that at the time the reforms started, the welfare gap between cities and rural areas on the one hand, and East and West on the other, was very small. *Jian* (1996) disagrees, providing evidence that during the cultural revolution (1965-1978), regional inequality widened, as Socialist planning favored the already richer industrial regions at the expense of the poorer agricultural regions. It was only after market-oriented reforms began in 1978 that regional incomes began to equalize sharply. This convergence was strongly associated with the rise in rural productivity, and was particularly strong within the group of provinces that were allowed to integrate with the outside world.

16 Geographical differences, but also because differences in 'risk attitude' might also be important factors determining regional performance. For instance, one reason why Western provinces are lagging behind is that Western people are said to be more conservative and more risk-averse.

17 Interpress Service News Agency, March 29, 2006. Note that due to statistical differences the figures for urbanisation are not internationally comparable.

18 For instance, one person reported having a dual pension, partly paid by the state and partly by his former employer. When retiring in 2002, the total pension amounted to 400 rmb per month (200 from his company, 200 from the state). While company benefits stayed constant, state pension payments had more than tripled to 630 rmb per month in 2006.

19 The costs to collect farm taxes exceeded their revenue, so abolishing them might actually be revenue-enhancing.

20 In the last century, China had two major revolutions, a civil war, the Great Leap Forward, the Cultural Revolution, and a major economic transition since 1979. It would be surprising if China could complete the ongoing transition from a planned to a market economy without major setbacks.

21 In recent years inflation in Shanghai – including property prices – reached 10-20 percent. Policymakers have responded to the house price increases in cities by tightening credit allocation, e.g. by restricting the possibility to use mortgages to buy a second house. Note also that early half of Forbes' list of the 100 richest individuals in China in 2004 were in the real estate business.

22 Important past landmarks were e.g. that gdp per capita were to exceed usd 1000 by 1990; current economic goals are that gdp should quadruple by the year 2020.

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