［主题报告］

# China’s Economy:

## Recent Developments and Further Study

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I am delighted to participate in this symposium to celebrate the establishment of the Center for Chinese Studies at Aichi University.

This paper covers two topics, first, China’s recent economic development in the context of economic globalization, and second, my approach to the study of the Chinese economy.

### Economic Development of China

Since the Opium War of 1840–42, the dream of the Chinese people was to modernize their country. Today China’s modernization is already accomplished as the foundation has been laid and it is just a matter of time for modernization to be completed. A more optimistic view was expressed in an article in *Financial Times* published on Monday, September 22 with the headline, “Why Europe was the past, the US is the present and a China-dominated Asia the future of the global economy.” I agree with this view. For this audience there is no need for me to point out that Japan will play a very important role in the future of the global economy. The phrase “China-dominated Asia” is based on the very large population of China. In terms of per capita income, it will take a long time for China to catch up with Japan.

In my book *China’s Economic Transformation* (Oxford: Blackwell Publishers, 2002, p. 103) I have forecasted that by 2020 China’s economy will surpass the US economy in total output. How can such a forecast be made? The first step is to study the important factors that have contributed to China’s economic growth in the past. The second step is to ask whether these fundamental forces will remain in effect in the future. If yes, we are justified in projecting past trend into the future with due allowance for possible modifications.

In the last twenty-five years China’s economic growth has been considered an economic miracle. For a country as large as China, an average growth rate in total output of 9.6 percent per year for the first twenty years of economic reform after 1978 is phenomenal. It is as good as or surpasses the best record of any fast growing economy, including Japan, Hong Kong, Taiwan and Singapore during their most rapidly growing 25 years. What account for this economic success? There are three fundamental factors. The first is the high quality of China’s population, what the economists call human capital. This includes the hard-working and skillful labor force and the resourceful and talented entrepreneurs. Second is a set of well-functioning, though imperfect market institutions. Third, China is a late comer. This enables China to take advantage of the technology invented by the developed economies through many decades. For the same three reasons the other economies that I have just mentioned succeeded in rapid development before China. The Chinese government deserves credit in guiding economic reform from a centrally planned economy to a market economy, but the Chinese people deserve perhaps even more credit by their skills, resourcefulness and energy in building the Chinese economy. Here I should mention the contributions in the form of financial and human capital of overseas Chinese that include in particular those residing in Hong Kong, Taiwan, Singapore and the US. Most other developing countries have not had such good fortune in their effort to develop the economy.

These three fundamental economic factors are likely to remain in effect in the next two decades because there is no reason for any one of the three to change. Therefore we can expect China's rapid growth to continue. The rate of growth will not be as high as it has been in the last few years which is in the order of almost 8 percent. Growth will slow down as compared with the average rate of the last 25 years because in 1978 China started from a low base, the change from a planned to a market economy stimulated rapid growth, and the effect of a late comer will be weaker as the technology level of the Chinese industries is raised. To forecast China's growth up to 2020 we should apply a lower growth rate than in the past. I started with the World Bank's estimate of China's real output in 1998 measured in US dollars (of comparable purchasing power) which equaled half of the US output. If we were to project a 6 percent annual growth for China from 1998 to 2020 it would take a 2.9 percent annual growth for the US in the same period to match China's total output in 2020. Since a 6 percent rate for China is somewhat conservative (the rate from 1998 to 2003 was close to 8 percent), and the 2.9 percent growth for the US is reasonable (the rate from 1998 to 2003 was less) we can expect that the total output of China will catch up with or surpass the US output by 2020. Of course per capita output of China in 2020 will be about one fifth of the US output, but in terms of national economic power, total output is a better indicator than per capita output.

## Problems and Short-comings of the Chinese Economy

On Friday September 26 *China Daily* reports that Premier Wen Jiabao in a speech on the Chinese economy focused on the following major issues: state enterprise reform, employment, social security, and sustainable development. I will start with enterprise reform. China's state-owned enterprises used to perform two functions, production (a function of private enterprises in a market economy) and the provision of social welfare. The latter includes job security, old-age support and health care for the employees. Therefore, the first three issues mentioned by Premier Wen are all related to enterprise reform.

### 1. Reform of state-owned enterprises

China's economic reform has been a gradual process, taking many steps with each step guided by the experience of the previous step. As Deng Xiaoping said, it is like crossing a river by feeling the rocks. Deng also advised his Party members, "Seek truth from facts." In the case of the reform of state-owned enterprises, after experimenting with several thousand enterprises in 1980, the first step was to give the enterprise some autonomy in their output and production decisions and to allow them to keep their profits after paying taxes to the government, A second major step was to allow the enterprises to keep all the profits after paying a fixed amount of tax to the government. This was introduced in 1987 under the name of "contract responsibility system." A major step introduced in the late 1990s was to restructure all state enterprises to become share-holding companies. The government would maintain ownership and control of the very large and important state enterprises, but give up ownership of the small and medium sized enterprises. Shares of small and medium sized state enterprises were sold to their managers, staff and workers. This provides additional capital for the restructured enterprises and economic incentives to the employees who, as share holders, will share the profits.

The State Economic Commission was given the responsibility to restructure the large state enterprises in the late 1990s. Reform of the state enterprises which were under the jurisdiction of the national government, the provincial governments or the city or township governments was directed by the offices of the State Economic Commission at the corresponding government level. Restructuring required downsizing and created unemployment. The problem of unemployment was not serious because the rate of restructuring was monitored by the State Economic Commission. The office of the Commission at each level had a finite budget, and downsizing required compensation to the laid-off workers at approximately one third of their wage. Given a limited budget the office of the Commission could only downsize a certain number of state enterprises in a given year. Furthermore, the laid-off workers could find jobs in the market economy, and many did. In certain areas including the North-Eastern provinces where there was a high concentration of large state enterprises, the problem of employment due to restructuring was more serious, but the government recognized the problem and tried to control the speed of restructuring in a period of several years.

In the mean time, the national government was solving the problem of providing social welfare formerly provided in the urban areas by the state enterprises. Since the mid-1990s, the Chinese government has attempted to set up step by step a nationally unified social security system for the urban population, under the central management of the labor and social security administration departments and with social insurance funds partly contributed by the central government. Labor and social security departments at all levels are responsible for the collection, management and payment of the social insurance funds. Besides contributions from employers and employees as stated below the central government allocated 98.2 billion yuan in 2001 for social security payments, 5.18 times the amount in 1998 as it was expanding the system to cover larger segments of the population in steps. (All statistics on the development of the social security system can be found in the website of *The People's Daily*, http://english.peopledaily.com.cn/ under "White Paper on Labor and Social Security in China" in the section "White Papers of Chinese Government.")

In 1997, a uniform basic old-age insurance system for enterprise employees was established, financed by 20 percent of the enterprise wage bill and 8 percent of the employee's wage. A part of the premiums from enterprises go to mutual assistance funds and the rest to personal accounts while the premiums from the employees go entirely to personal accounts that belong to the employees themselves and can be inherited. Employees participating in this program increased from 86.71 million in late 1997 to 108.02 million at the end of 2001 while the number receiving pensions increased from 25.33 million to 33.81 million, with the average monthly basic pension per person increasing from 430 yuan to 556 yuan. The rural populations pay their own insurance premiums and withdraw funds from personal accounts with subsidies from the government.

In 1999, an unemployment insurance system was introduced, financed by 2 percent of the wage bill paid by employers and 1 percent paid by employees. Unemployment insurance benefits are lower than the minimum wage but higher than the minimum living allowance guaranteed for all laid-off workers. The period of drawing insurance depends on the length of the period in which insurance payments have been paid, with 24 months as the maximum. The number of persons insured increased from 79.28 million in 1998 to 103.55 million in 2001.

On health care, important policies were announced on January 15, 1997 in the "Decision on Health Reform and Development by the Central Party Committee and State Council." The basic objective of the Decision is to insure that every Chinese will have access to basic health protection. For the rural population the strategy is to develop and improve the "Cooperative Medical System" (CMS), which had funded and organized health care for almost the entire rural population but broke down after economic reform, through education, by mobilizing more farmers to participate and gradually expanding its coverage. In 1998, a basic medical insurance system for urban employees was established, financed by 6 percent of the wage bill of employing units and 2 percent of the personal wages. By the end of 2001, 76.29 million employees had participated in basic insurance programs. In addition, free medical services and other forms of health care systems covered over 100 million urban population. The Chinese government has a policy to provide basic care for the entire population.

**2. Banking and financial system**

Since the early 1980s the Chinese government has tried to transform its banking system to a modern system with a central bank and a large number of commercial banks. In 1982, the People's Banks was declared a central bank although it could not function as one because there were no properly functioning commercial banks. 1995 was an important year for banking reform when both a Central Bank Law and a Commercial Bank Law were enacted by the National People's Congress. These laws have provisions very similar to the laws governing the Federal Reserve Bank and the commercial banks in the United Sates, except for the fact that the Federal Reserve Bank in the United States is independent of the executive branch of the US government whereas the People's Bank is under the direction of the State Council. Since Chinese commercial banks do not have sufficient well-trained staff to perform the functions of modern banking, the management is subject to political pressure to extend loans to state enterprises for the purpose of economic development of the region in which they are located, the bureaucratic behavior of the management and staff is not easy to change, it will take time for the Chinese commercial banks to operate efficiently to serve the proper function of channeling saving to the most promising investment projects. China's entry to WTO will provide competition to the state-owned commercial banks and make them more efficient gradually.

In the short-run there is a large amount of bad loans in the balance sheets of China's commercial banks. Some of these loans originated in a period when the banks had to provide credit to state enterprises under the direction of central planning, while others were extended in the 1980s and 1990's to state enterprises by political pressure in the name of economic development. The bad loans will not lead to a banking crisis in the form of bank runs because the Chinese people will not withdraw their deposits en mass for fear of losing their money. They believe that since the banks are owned by the government and the government in effect guarantees their deposits. In 1999, the government set up four Asset Management Companies, one for each of the four state-owned commercial banks, to convert the bad loans to better assets for the banks. The amount of bad loans has been gradually reduced.

**3. A less developed Western-style legal system**

It has been pointed out that China does not have a modern Western-style legal system and hence Chinese business transactions cannot be performed effectively. The first part of this statement is correct and the second part is questionable. It is true that in spite of the effort of the government to modernize China's legal system in the last decades, it is still not up to the modern standard of the Western developed economies. Institutional changes by new legislation do not by themselves change the legal behavior of the Chinese people which has been influenced by culture and history. The Chinese people do not emphasize formal laws, but regard moral and ethical standards as more important in regulating personal behavior and safeguarding social order. There is a social network called *Guanxi* that regulates relations among people, and can be used to settle disputes in lieu of law suits. As an illustration that a Western style legal system is not necessary, witness the rapid growth of the township and village enterprises in China in the 1980s and 1990s that became a most dynamic sector of the Chinese economy and these enterprises did not operate under the protection of a modern legal system. As a second illustration, in the last ten years, economic growth of Shanghai surpassed that of Hong Kong but Hong Kong has a much better Western-style legal system in place. The Shanghai people have their way to handle their business transactions that are effective but not a Western legal system. China's government is eager to develop a modern legal system as an important part of its modernization effort and to enable Western investors to operate more conveniently in China. Just because the ways to conduct business in Asia are not the same as in the West, one cannot conclude that these ways are ineffective and the market institutions in Asia are a form of "phony capitalism" as the term is used by some uninformed Western observers.

## US-China Economic Relations

I will discuss the topic of US-China economic relations not only because it is important for the understanding of the Chinese economy but also because some observations are also applicable to US-Japan economic relations. I will briefly discuss China's foreign investment and foreign trade in the context of the world economic globalization process.

Deng's open-door policy has contributed a great deal to the rapid economic growth in China. Foreign investment has helped China's growth by importing financial and physical capital, technology and management know-how, and by providing competition for China's domestic enterprises to make them more efficient. About 60 percent of China's exports are produced by foreign-operated or foreign-financed enterprises in China.

From the US point of view there are serious criticisms of American manufacturers moving their operations to China. Investing in China is said to be exporting jobs to the Chinese workers at the expense of American workers. Is a move of an American factory to China a good thing for the US? I believe that it is essentially good. Let us perform the following economic analysis of the effects of having one factory moved from the US to China.

Other things being equal, moving one factory from the United States to take advantage of the low-cost labor in China will lead to a higher national income for the United States as a whole but a lower employment and lower wage for the workers. When physical capital is moved with the factory to China, there will be less capital and hence reduced total output in United States. But the capital that is moved will earn more in China to compensate for the loss of output in the United States; otherwise the move will not be made. This leads to a net increase in the US national income since the value added for the moved factory is a part of national income of the United States. As factories are moved to China, the United States gains in total national income or output, but the wages and employment of the workers in these and similar factories in the United States will be reduced. The people, including workers, owning stocks of the companies that move their factories to China will gain.

In the above analysis I have not considered other things that may happen. Competition from low-cost labor in China will provide incentives for US workers to improve their skills to find new jobs and for US entrepreneurs to develop new products or services to employ the labor now available. This is a part of the economic globalization process. I have just pointed out its desirable effect on China by providing capital, technology and managerial know-how to China and foreign competition to stimulate the Chinese domestic enterprises. The United States has an abundance of capital relative to labor, while China has an abundance of labor relative to capital. As capital moves from the United States to China, it will lower the return to capital in China and lower the wage rate in the United States, but it will raise the wage of the Chinese workers and raise the return to American capital. Both economies will have to find adjustments to weather the impact. In the long run both countries will be better off as their national incomes will increase at a faster rate as a result of economic globalization.

China's economic expansion has several favorable effects for the United States. First, as I have just pointed out, China provides investment opportunities for US investors. US corporations setting up factories in China can increase their profits which are good for their stockholders and for raising total national income. Second, China provides a large market for goods produced in the United States and helps to increase employment in the industries producing such goods. Third, China produces a large number of inexpensive and high-quality consumer goods being exported to the United States to benefit the American consumers. Economic cooperation with China is therefore beneficial to the United States and to China as well.

Concerning foreign trade, a main issue from the viewpoint of the United States is the trade surplus of China. Japan used to have the largest trade surplus with the United States. Last year, China just replaced Japan in having the largest trade surplus with the United States. There is pressure from the United States to reduce this surplus, or trade deficit from the US point of view. One way to do this is for China to revalue their currency RMB, making the Chinese goods more expensive in the United States. In September 2003, Secretary of Treasury John Snow of the United States openly pressured the Chinese government to revalue or appreciate its currency. The issue of possible revision of the exchange rate of the RMB has received much public attention. Should China revalue its currency? Will it? My answer is, yes it should, and yes it will.

On the first question, it should revalue if the official rate is below the market-determined rate. It is a general principle in economics that if the government tries to control price and set it as a rate different from the rate determined by market forces of demand and supply, economic problems will arise. Let me illustrate this principle using the current exchange rate of the Chinese RMB. The official exchange rate of 8.3 RMB for one US dollar was set in 1994 and it appeared to be close to the market equilibrium rate. In the long run, purchasing power parity determines the rate of exchange rate. Let us consider the market forces of demand for the supply of Chinese RMB. If the demand is high, and/or the supply is low, the price of RMB should go up. On the demand side, to pay for the Chinese exports, American importers demand a lot of Chinese RMB to pay for these goods produced in China and give up US dollars to exchange for the RMB. This raises the price of RMB. Foreign investment requires the exchange of US dollars for Chinese RMB to pay the expenses that the investment requires. This also bids up the price of RMB. In addition, there is accumulated a large amount of foreign reserve in the order of 360 billion US dollars. When China has so much of it, the price of US dollars tends to go down.

There is economic pressure from holding such a large amount of foreign reserve to utilize it. The Chinese Central bank has bought a large amount of US treasury bonds using this money that leads to raising the price of bonds and lowering the interest rate in the US. This is not an efficient way to use the reserves. Once there is enough foreign exchange to protect the value of a country's currency in international trade, the main purpose of exports is to earn money so that the country can buy imports for the people's consumption or for economic development. This requires reducing the trade surplus by importing more. An appreciation of RMB can achieve this and at the same time makes imports from the US cheaper for the Chinese consumers and investors engaged in developing the Chinese economy. Failure to revalue also creates problems for the People's Bank as it is forced to increase the supply of RMB in China when the exporters earning US dollars exchange the dollars for RMB. A large increase in the supply of money in China can lead to inflation unless the government finds ways to reduce the amount of money in circulation. Chinese banks holding a large amount of money will lend it out, possibly leading to investment booms that can burst.

There is also the force of speculation. Once people realize that the RMB is undervalued, they will spend US dollars to buy it to make a profit in the future. Speculation will increase the pressure for revaluation since it will increase the supply of dollars in exchange for RMB and tend to increase the value of the RMB further. Because of such fundamental economic forces, the Chinese government should and will revalue the RMB.

In my book *China's Economic Transformation*, p. 76, I observed some of these fundamental economic forces and predicted that the RMB would appreciate in value in the future. It is only a matter of time that revaluation will take place. I thought the government would do it soon because the officials understood the economics as I have just discussed. Political pressure from Treasury Secretary John Snow in September 2003 could be counter-productive because the Chinese government would not wish to appear to succumb to US political pressure. If the US government keeps quiet, the Chinese government will find an appropriate time to raise the value of the RMB. It cannot afford to wait very long to act as the economic pressure is great.

### Impact of WTO Membership

I have also been asked to address the impact of WTO membership on the Chinese economy. This question was discussed in *China's Economic Transformation*, pp. 77–83 and I will only summarize the main points here. Concerning the impact on China's economic institutions, provisions of WTO membership allow foreign competitors to sell agricultural and manufactured goods in China at lower prices as a result of agreed tariff reductions, to sell products in the Chinese markets directly without going through Chinese agents, and to set up foreign firms in manufacturing, financial, service and telecommunication sectors in several steps to easy the transitional problems for the domestic firms facing such competition. Foreign competition to stimulate domestic firms is the key reason for China's entry into WTO. Competition will take effect gradually, and is unlikely to be too severe for the Chinese firms to handle because local governments can monitor the speed of entry of foreign firms to insure that the local firms can survive the foreign competition. I also discussed the positive impact on China's legal system and political system. Reform in both will be hastened but changing legal and political institutions is a slow process, for China and for most other countries as well.

### Study of China's Economy

Now I come to my second topic, methods to study the Chinese economy. I will be brief because I will have an opportunity after this session to discuss this topic with colleagues of the Center who are responsible for economic studies. Following the theme of this conference, "towards the construction of a new and modern Sinology" I would like to present my view of a "new and modern Sinology" in the study of the Chinese economy. This view may not apply to the study of other aspects of China. Does the study of the Chinese economy require a different set of tools, other than proficiency in the Chinese language, from what we use in the study of economics in general? My answer is mainly no but partly yes. I believe that the modern theory and method of economics are applicable to China as I have demonstrated in my book *China's Economic Transformation* and other books and articles referred in it. I have studied inflation in China using an modern econometric model of cointegration, economic growth using a production function, the rate of return to schooling in China using a well-known equation, the determination of prices of stocks traded in the Shanghai Stock Exchange using a well-known equation which I had successfully applied to explain stock prices of the New York Stock Market and the Hong Kong Stock Market. Hence the application of modern tools in economics to study the Chinese economy is feasible and fruitful. This is the "yes" part of my answer.

The "partially no" part of my answer is based on two considerations. First, one needs to understand the Chinese historical, cultural, social and/or political conditions in order to apply modern economic analysis to problems of the Chinese economy. One example is in Chapter 15 of *Chinese Economic Transformation* dealing with the behavior of a Chinese state-owned enterprise. I had to construct two modes for the Chinese enterprise at different stages of economic reform that are different from the standard model for an American private corporation. Even in the analysis of the problems cited in the last paragraph, I had to use my judgment based on knowledge of Chinese economic institutions before proceeding to apply a standard economic theory. In the case of studying the determination of the prices of stock traded in the Shanghai Stock Exchange, I could not assume that the same equation used for the New York and Hong Kong Stock Exchanges would work, and only found out later that it did work. Second, as we study China, or another non-Western country, we will discover new ideas and new tools that are useful for the study of economics in general. Therefore, the study of the Chinese economy is not simply an application of modern economic tools that have been developed mainly in the study of Western economies, but will also lead to the advancement of economics as a science.