



# **Challenges to Chinese Growth**

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# The Rise of China

*Table 1*

	Number of Countries	Pop. (million)	PPP GDP	Growth Rates, 1990-2005	
				GDP per capita	Exports
USA	1	296	3.0	1.9	4.7
Japan	1	128	1.3	1.0	3.8
Rest of high Income	22	496	2.3	1.8	5.4
China	1	1304	9.6	8.7	15.0
India	1	1095	5.7	4.0	8.9
Rest of dev Asia (RODA)	17	843	4.5	2.7	8.5
Latin America	29	539	3.0	1.4	7.9
Sub-Saharan Africa	41	711	2.7	0.2	3.9
Eastern Europe/ Central Asia	14	324	0.2	0.1	8.6
Middle East/ N Africa	11	275	3.9	2.0	5.9
World	138	6012	3.4	2.0	6.1

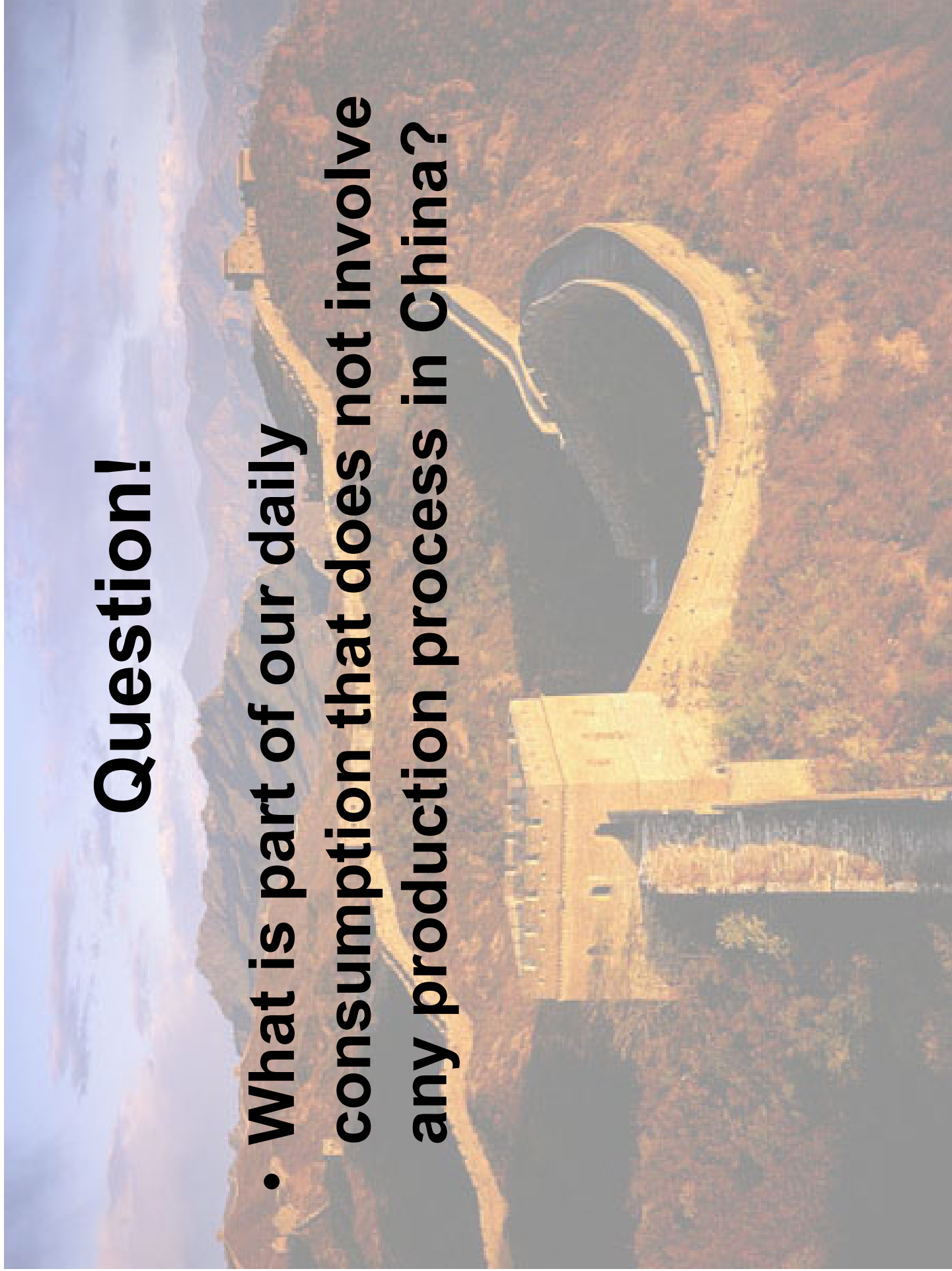
Sources: World Development Indicators; World Bank WITS database.

# **Why So Much So Fast?**

- **Abundance of labor (rural and urban)**
- **Good Investment Environment (SEZs, liberal foreign investor policy, open door policy)**
- **WTO membership (promote economic/trade reforms)**

# Question!

- **What is part of our daily consumption that does not involve any production process in China?**



# Issues with Growth

- **Dealing with Capital Account Surplus – Domestic financing of FDI**
  - Giving foreign investors access to local funds in China will help address the twin problems of having too much ‘surplus’ in capital and too much ‘deficit’ in advanced technology and efficient management practices.
    - Allow foreign investors to borrow in RMB locally
    - Listing of foreign companies in China
    - Allow foreign private equity investors to tap into local funds
- **Dealing with Capital Account Surplus – Active Management of foreign reserves**
  - Need to put aside some international reserves to be actively managed (less precautionary liquid reserves) to enhance investment returns
    - Can set up separate investment company that behaves like LT global endowment fund, maximizing LT returns. Government can capture longer-term risk and liquidity premiums unavailable at central bank, fortify country’s external balance and creditworthiness position
  - Have to decide on a return target and an asset mix based on policy risk tolerance.



# Issues with Growth

- **Macroeconomic Adjustment**
- **Macroeconomic Policy – Exchange Rate Pressure**
  - **A single policy instrument cannot be used to target more than one thing (ie, interest rate to control exchange rate and inflation targeting)**
  - **Process of exchange-market intervention threatens domestic monetary and macroeconomic control**
- **The pressure on the exchange rate caused by market perception of an undervaluation or overvaluation of currency which may accelerate and magnify the LT effects of a wrong level of exchange rate.**

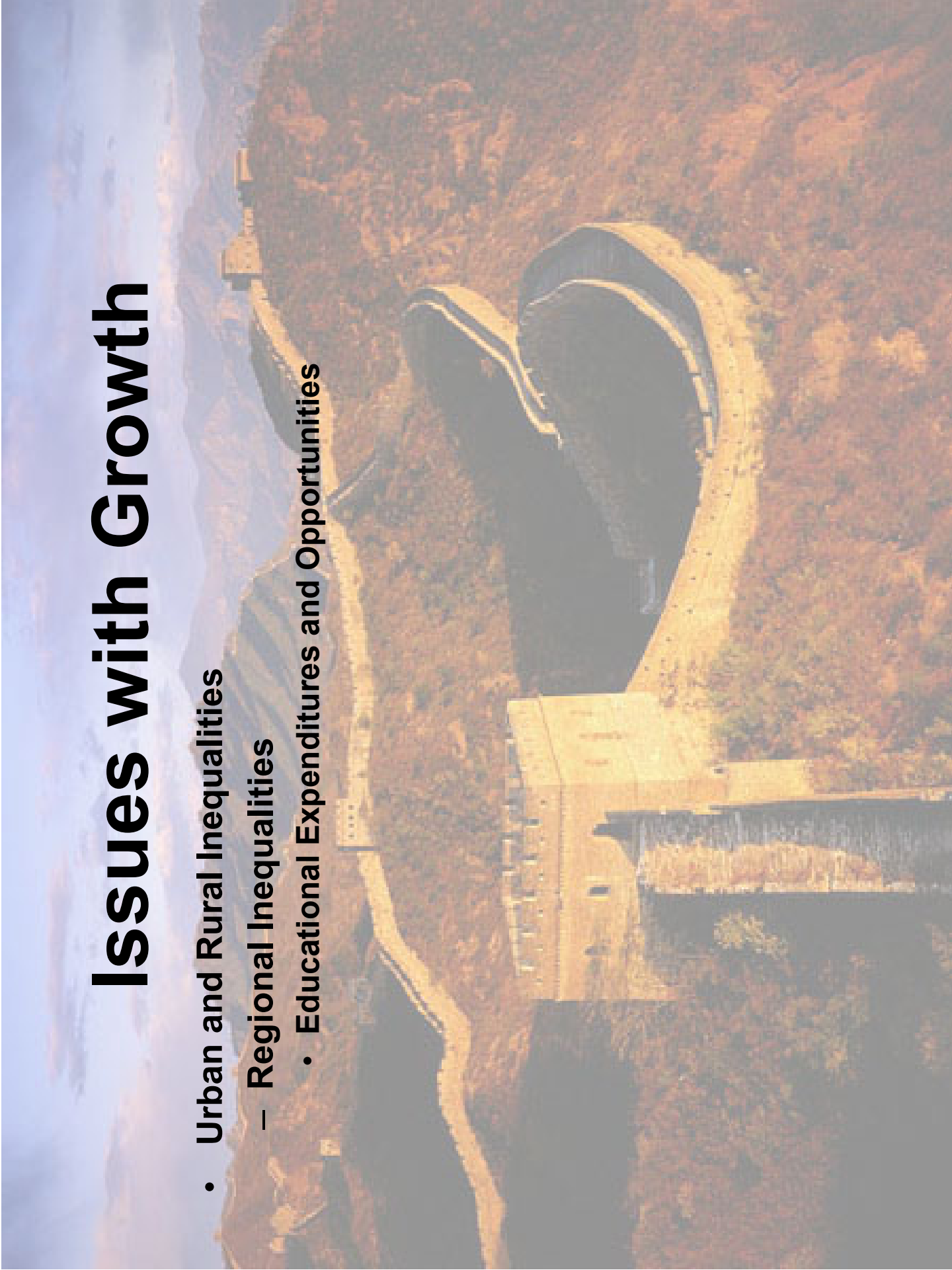
# Issues with Growth

## Macroeconomic Adjustment

- **Appreciation of RMB**
  - **Appreciation of RMB is required for increasing consumption to achieve better balance in the domestic economy**
  - **Reduce export demand and allow more imports to meet the increase in domestic demand**
  - **Exact appreciation amount is unknown; response of Chinese imports/exports to price changes is unclear.**
  - **Too small an appreciation in RMB combined with a large expansionary public expenditure program may result in overheating and inflationary pressure, need careful planning so that supply will be able to respond to the increased demand**

# Issues with Growth

- Urban and Rural Inequalities
  - Regional Inequalities
    - Educational Expenditures and Opportunities





# Issues with Growth

- Energy and Environment
  - Air pollution from burning fossil fuels might cost the Chinese economy as much as 2% of GDP annually
  - Sulphur-dioxide (SO<sub>2</sub>) emissions from burning fossil fuels have local and regional (acid rain) implications
  - China reacted with a range of SO<sub>2</sub> control policies which caused emissions to fall from 1995-2002, but it has been on the rise again.
  - China has ratified the Kyoto Protocol, an international agreement to limit emissions, but China does not have any binding targets
  - China would be better off implementing a hybrid system of market incentive and government controls such as the approach outlined in McKibbin-Wilcoxon Blueprint – establish a system of property rights over carbon-dioxide emissions, based on long-run targets for emissions where a market is established to trade these rights for a price.

# Maintaining Growth

- Urbanization
  - Shift labor away from a barely productive rural agricultural sector to industry and urban services
  - Productivity is 30-35% higher for one country one standard deviation above average in nearness to population centers
  - Agglomeration externalities make workers more productive and workers tend to have higher wages in urban centers
  - Free-ride problems on common resources leading to congestion, pollution, and higher crime rates
  - Policy Recommendations:
    - Eliminate *hukou* policy so migrant workers can gain access to jobs, housing and social services.
    - Localities that absorb new migrants should be compensated for extra burden migration imposes on local services.
    - Strengthen internal labor market by reforming pension system to ensure pension is portable across provinces

# Our Point of View

- **Eliminating Hukou policy may cause social unrest in urban areas; resources will become more scarce**
- **Housing availability and affordability is an issue for migrant workers with little to no capital assets**
- **Subsidies should go not only to local governments, but to the actual migrants as well to compensate for lost rural property and transitional living expenses. (Due to changes in living standards and cost of living across provinces.)**

# Maintaining Growth

- **Maintaining Manufacturing Export Dynamism**
  - **If China does not make efforts to upgrade its exports, they may face deteriorating prices, profits and growth as the terms of trade deteriorate.**
  - **Policies need to focus resources on encouraging new activities that can have demonstration effects or informational or technological spillovers.**
  - **Policies need to subsidize the costs of experimentation: adaptation, labor training and supply-chain development.**



# Our Point of View

- For China to upgrade its exports, the labor force needs to be more educated on average, need to provide educational subsidies
- Invest in R&D to yield long term technological spillovers, not just focus on short term profit margins
- Provide certain tax breaks or other incentives for R&D to encourage IT developments



# Maintaining Growth

- **Service-sector Productivity**
  - **Service-sector lacks FDI and competition**
  - **Restrictions on FDI that seeks access to the domestic market should be relaxed in order to encourage competition and innovation**
  - **There should be faster licensing for self-employed businesses and lower license fees for small enterprises.**
  - **Business process outsourcing should be stimulated, especially within China, where language barriers are not an issue and where there are ample opportunities to tap the labor supply from Central and Western regions.**

# Our Point of View

The background of the slide is a photograph of a traditional Chinese stone wall and a circular stone structure on a hillside. The wall is made of large, weathered stones and has a crenelated top. The circular structure is a stone well or a small fortification. The hillside is covered in dense, green trees. In the background, there are mountains under a clear blue sky.

- **Since Chinese technology may not be as advanced as that of foreign investment, there may be growing protectionist sentiments among the locals about the sustainability of businesses in the face of foreign competition.**
- **Business processes may be stunted in areas that lack informational infrastructure and create an asymmetry of information.**

# Maintaining Growth

- **Agricultural Productivity and Rural Poverty**
  - **Policies need to be created to foster freer land markets against community seizures and transfers so to increase migrants' access to leased land.**
  - **Agriculture-specific taxes should be replaced by taxes that are neutral among income sources.**
  - **Rural finance is crucial for development; introduction of private lenders would help stimulate competition.**

# Our Point of View

- **Migrants may suffer from information asymmetry when leasing land**
- **How should agricultural income sources be valued? By FMV (which may be subject to while fluctuations due to world market and climate conditions across regions)? How should crop yield for personal use be accounted for? Should there be exemptions?**
- **When private lenders stimulate competition for local banks, local banking system may be sophisticated enough to compete.**



# Maintaining Growth

- **Efficiency of Investment**
  - **Low productivity of investment is due largely to SOEs which have had preferential access to bank loans, funds invested in SOEs are not spent in high yield activities.**
  - **SOEs should be required to distribute dividends to the government, these dividends may be reallocated to other sectors or to fund greater investments in human capital.**



# Our Point of View

- If SOEs take on higher yield activities, higher risks may create a loss on benefits for those urban workers.
- With the historical losses of SOEs, it may take longer for SOEs to earn enough to distribute dividends.

# Maintaining Growth

## Internal Trade Integration

- Policymakers opened some regions and not others to FDI (SEZs).
- A policy to homogenize investment policies should help lower policy-induced regional imbalances, while a policy that improves the quality of the transportation and communication infrastructure would reduce disparities caused by transportation costs.
- Provincial and sectoral barriers to internal integration constrain the ability of resources to move to their most productive use and which limit the competitive pressures that foster greater productivity and innovation.
- Domestic integration will also facilitate the location of firms in areas that are farther from the coast but well located in the large domestic market, lowering regional imbalances.
- Growth of domestic demand is more likely to be met by domestic supply than by imports if these internal efficiency improvements are in place.
- Reduce restrictions on foreign firms selling in the domestic market, eliminate the hukou policy.

# Maintaining Growth

- Investment in Human Capital
  - Allocate funds to support public health and basic prevention programs in low-income regions
  - Establish a nutrition program for the poor
  - Expansion of the social health insurance to cover workers employed by small firms and the informal sector, such as migrants and their families
  - Restoration of community-based insurance scheme for the rural population (*foot doctors*).

# Are these solutions possible?

- David Dollar's two states
  - Bad state
    - Recession?
    - Global warming issue?
    - Inequality
  - Good State
    - Increase in trade?
    - Reduce global warming stress?
    - Competitive advantage in labor-intensive sectors?
- Any ideas?

**Thank you!!**

