

Strategy for Chinese Economic Growth

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The Supply Side

- ◆ The Chinese economy has a long-term rate of potential growth of approximately 8 percent, based on considerations of the expected growth of both tangible (physical capital and labour) and intangible inputs (human capital and R&D capital).
- ◆ China has strong economic fundamentals:
 - ◆ (1) An unlimited supply of surplus labour--The primary sector currently accounts for 10% of Chinese GDP but almost 40% of the Chinese labour force (compared to 70% in 1978). This implies an absence of any upward pressure on the real wage rate of entry-level, unskilled labour in the non-agricultural sectors for many more years to come.
 - ◆ (2) A consistently high domestic savings rate of greater than 30 percent on average and occasionally exceeding 40%, which is more than adequate to meet the needs of growth of physical capital in the Chinese economy.
 - ◆ (3) A huge domestic market of 1.3 billion consumers, which permits the full realization of economies of scale in production in every industry based on domestic demand alone.

The Supply Side

- ◆ Chinese capital intensity, i.e., capital per unit labour, even after sixty years of rapid tangible capital accumulation, is still way below those of developed economies, and still has room to grow as a source of increase of productivity.
- ◆ And the movement of the labour force from the primary sector to the other two sectors, complemented by the growth of the tangible capital stocks in these sectors, will continue to be a major source of output per unit labour and hence economic growth.
- ◆ Even discounting for the inefficiency of many Chinese investment projects, tangible capital remains the most important source of growth for the Chinese economy.
- ◆ These fundamental factors are unlikely to change during the next several decades although technical progress, or growth in total factor productivity, is expected to become more important as a source of economic growth as investment in human capital and R&D and other forms of intangible capital increases.

The Chinese Advantages in Innovation

- ◆ In addition, the Chinese economy has the advantage of relative backwardness:
 - ◆ The ability to learn from the experiences of successes and failures of other economies;
 - ◆ The ability to leap-frog stages of development (e.g., the telex machine, the VHS video players, the fixed landline telephones); and
 - ◆ The possibility of creation without destruction (e.g., online virtual bookstores like Amazon.com do not have to destroy brick and mortar bookstores which do not exist in the first place).
- ◆ The large potential domestic market not only allows economies of scale in production to be fully realized but also enables active Chinese participation in the setting of product and technology standards and sharing the benefits of such standard-setting.

The Chinese Advantages in Innovation

- ◆ China has an abundance of scientific and technical manpower the cost of which is a fraction of the cost in developed economies. (According to the latest statistics, China has recently become the second largest producer of scientific articles indexed in the Science Citation Index (SCI) and the Social Science Citation Index (SSCI).)
- ◆ The conclusion is that the Chinese economy has the potential of growing at 7-8% per annum for as far as the eyes can see.

The Demand Side

- ◆ The important question is whether there is adequate sustainable aggregate demand to fulfill the potential capacity for economic growth.
- ◆ The Chinese Government has recently embarked on a economic stimulus programme of almost US\$600 billion over two years, equivalent to approximately 8% of Chinese GDP per year. Even taking into account that a significant proportion of the expenditures under the programme may not have been net additions, the economic stimulus should be sufficient to sustain economic growth for 2009 and 2010.
- ◆ However, government-driven investment (both public and private) alone may not be sustainable and may lead to even greater excess production capacity in certain sectors. What are possible sources of long-term sustainable aggregate demand?

The Demand Side

- ◆ The decline in Chinese export orders (as well as those of other East Asian economies) of almost 50% since mid-September of 2008 is due to the credit freeze in the importing countries rather than to a decline in their consumption demand or to the Chinese exports becoming too expensive.
- ◆ For example, aggregate U.S. personal consumption is unlikely to decline more than 5% in 2009. If that is the case, demand for imports is most unlikely to decline by more than 15%, unless the U.S. becomes very protectionist.
- ◆ The U.S. Dollar has actually been appreciating with regard to almost all East Asian currencies with the exception of the Japanese Yen, so that imports have become less rather than more expensive in U.S. Dollar terms.
- ◆ Moreover, Chinese (and East Asian) exports, which consist of mostly daily consumption goods targeted at the low-end market, should suffer even less from the decline in import demands as consumers switch from high-price to low-price items in an economic downturn.

The Impact of the Economic Recession in the World on Chinese Exports

- ◆ So the expectation is that the export orders should bounce back in a couple of quarters, that this decline in export orders is only temporary and basically represents a delay or postponement of the demand by a quarter or two because of bank credit constraints, as opposed to a permanent reduction in demand.
- ◆ But some categories of exports, such as furniture, large-ticket consumer durable items such as large-screen flat-panel television sets, refrigerators, washing and drying machines, notebook computers, will take much longer to revive.
- ◆ The Chinese enterprises should try to reorient these products to the large domestic Chinese market rather than to wait for the economic recovery in the developed economies.

The Impact of the Economic Recession in the World on Chinese Exports

- ◆ However, as Chinese export activities are not distributed uniformly over the entire country, but are concentrated in only a few provinces and municipalities, such as Guangdong (Pearl River Delta), Shanghai and Zhejiang (Changjiang River Delta), the declines in GDP and the rises in unemployment will be severe in the affected provinces and municipalities. The rates of growth of Guangdong and Shanghai in 2009 will decline from double-digit levels to 8.5% and 9% respectively. Measures must be taken to take care of the needs of the workers, especially the migrant labourers, laid off because of the export slump.

The Owner-Occupied Residential Sector

- ◆ One important source of sustainable aggregate demand is owner-occupied residential housing. Despite significant development of residential housing during the past thirty years, there is still a great deal of room to grow, especially in the interior provinces and regions and for the middle-to-lower-middle income households.
- ◆ Owner-occupied residential housing has been a major engine of growth for many countries and regions for decades during their periods of fastest economic growth. There is no question that there is a huge potential demand here in China.
- ◆ The demand for residential housing also generates with it the derivative demands for furniture, refrigerators, washing machines, television sets, curtains, carpets, household goods and services and with them a great deal of employment and activities for small and medium enterprises. It will generate demand for many products that face a sharply reduced export demand. It will help these enterprises to reorient themselves to serve the domestic market.

The Owner-Occupied Residential Housing Sector

- ◆ Two measures will greatly increase the demand for owner-occupied residential housing. First, longer-term, say thirty-five years, owner-occupied residential mortgages meeting certain criteria should be promoted. Second, fixed-rate mortgage loans should be offered for the duration of the loan period. These two measures will make residential housing ownership affordable (through the large reductions in the required monthly payments) and safe (through the fixed-rate feature reducing the risks of a variable interest rate) to a large majority of the households.

The Owner-Occupied Residential Housing Sector

- ◆ Long-term fixed rate mortgage loans made by commercial banks can be “toxic” because they do not have long-term fixed rate deposits and can easily get into trouble when the interest rate on short-term deposits rise. Thus a state policy bank, say, China Home Loan Bank, can be established to issue long-term fixed-rate bonds (potential purchasers are insurance companies and pension funds which have long-term funds and do not need the liquidity) and with the proceeds purchase qualified mortgage loans from the commercial banks.
- ◆ It is even possible for the rate of interest on such mortgage loans to be lowered since the state policy bank does not need such a large interest rate spread.
- ◆ In order that the market for residential housing, and hence the market for mortgage loans, functions properly, the rights of the home-owner owning the property and the rights of the lender, in the event of a loan default, must be protected.

The Education Sector

- ◆ This is the time to increase support for the education sector across the board—primary, secondary and tertiary.
- ◆ Both the physical structures as well as the human resources of primary and secondary schools need to be upgraded.
- ◆ In addition, China should adopt a policy to assure access to the internet by all students in China everywhere, all the way down to the primary school level. Promoting and making universal the laptop is one way to achieve this goal. Many Chinese households are able to afford the laptop—the difficulty is having inexpensive and ready access to the internet.

The Education Sector

- ◆ Making the internet accessible everywhere in China will greatly narrow the inequality of education (and information) between the urban and rural areas and reduce the so-called digital divide between the rich and the poor. It will be a great equaliser, because, for example, large and small enterprises will compete more or less equally on the internet.
- ◆ This will also create a great deal of domestic demand for the high-technology sector which faces a sharp and possibly long-term decline in their export markets.

Urbanization and Mass-Transit Systems

- ◆ Urbanization should be accelerated, but instead of making the existing cities larger and more crowded, new cities should be built in the rural areas, bringing capital and technology to labour rather than the other way around.
- ◆ Urbanization in the rural areas is possible only if the rural households currently with using their land can have their property rights recognized and made transferable.
- ◆ The communication and transportation infrastructure needs to be further improved. Central planning of new cities, regard to their locations, layouts and land use, is required.

Urbanization and Mass-Transit Systems

- ◆ Mass-transit systems should be the principal means of transportation for existing as well as new cities, and this also requires planning, preferably from the very beginning, and cannot be left to the market.
- ◆ With at least a couple of hundreds of Chinese cities say over 2 million in population and requiring mass-transit systems, the planning, designing, building and operating mass-transit systems can be a huge new industry with significant domestic and eventually export demand.
- ◆ In order to economise on the use of the scarce land resource, and to assure the efficiency and environmental friendliness of the urban transportation system, high density land use should be mandated in the cities.

Environmental Protection and Green Technologies

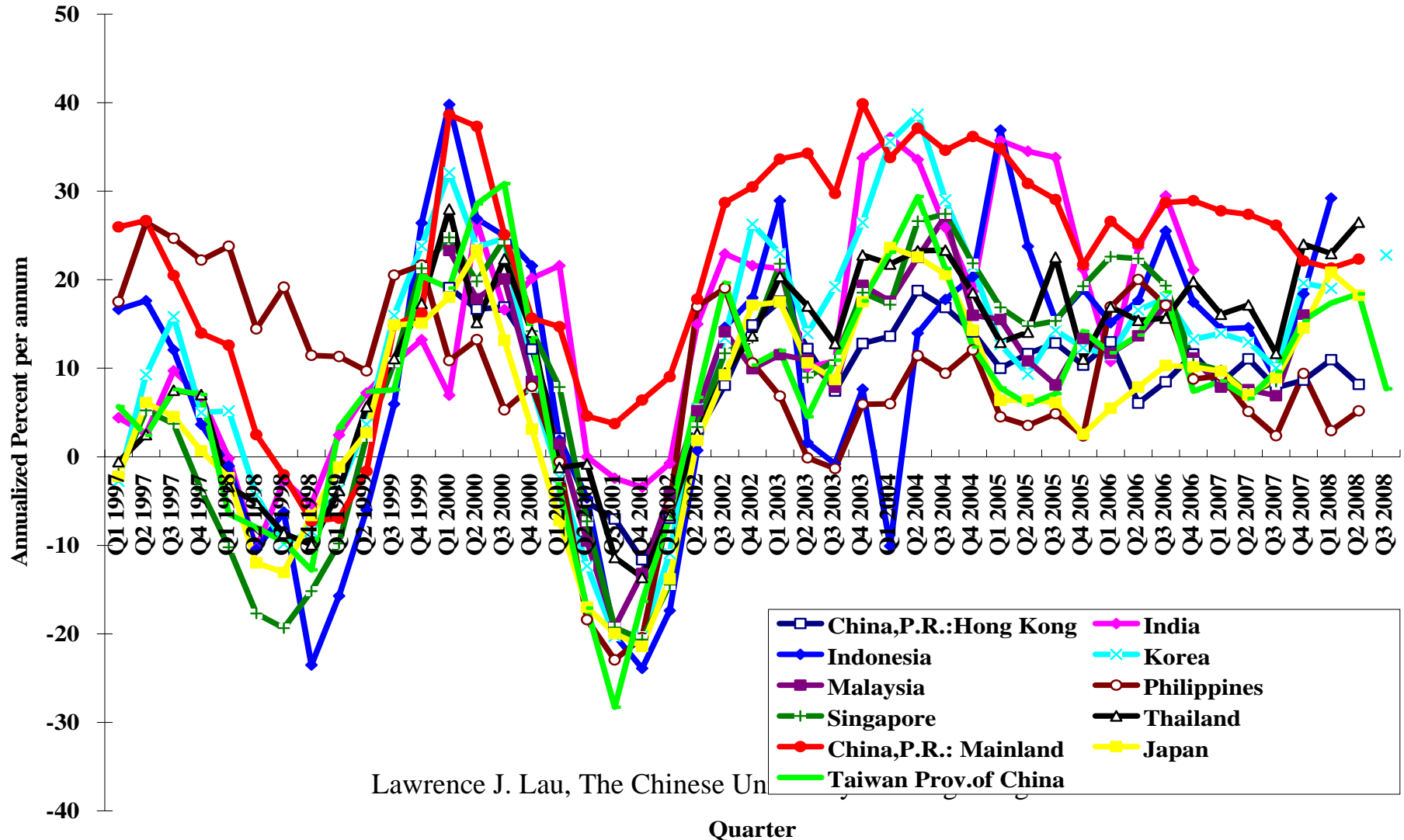
- ◆ Green technologies can find significant application in the residential housing sector—in terms of heating, cooling, lighting, provision of hot water, etc.
 - ◆ The mass-transit systems provide an indispensable alternative to the use of the automobile. “A car in every garage” would be a nightmare for China and for the world. Urban residents should not require the use of an automobile in their everyday life.
 - ◆ China has an advantage in introducing technologies for green or greener vehicles because it has relatively little sunk costs. China also has a substantial incentive in developing clean coal technologies, having large coal reserves itself.
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Vulnerability to External Economic Disturbances

- ◆ China is a large continental economy that has become largely dependent on its own domestic demand, just like the United States, and not too vulnerable to external economic disturbances.
- ◆ The experience of the East Asian currency crisis of 1997-98 provides evidence of the resilience of the Chinese economy. While rates of growth of Chinese exports and imports fluctuated just like all other East Asian economies during the crisis, the rate of growth of Chinese GDP has remained quite stable, as the following charts show.

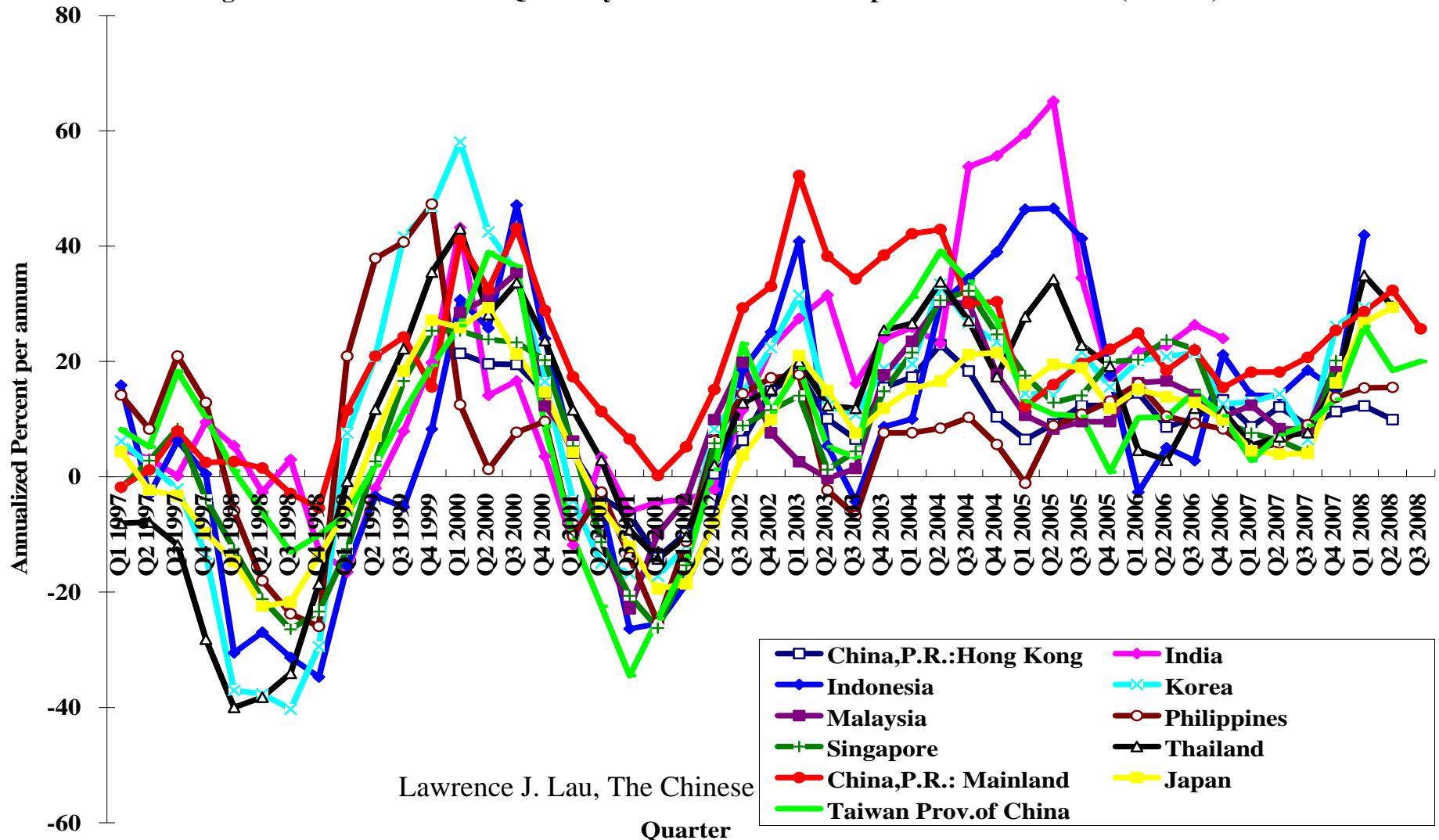
Quarterly Rates of Growth of Exports of Goods: Selected East Asian Economies

Figure 3.2: Year-over-Year Quarterly Rates of Growth of Exports of Goods in US\$ (Percent)



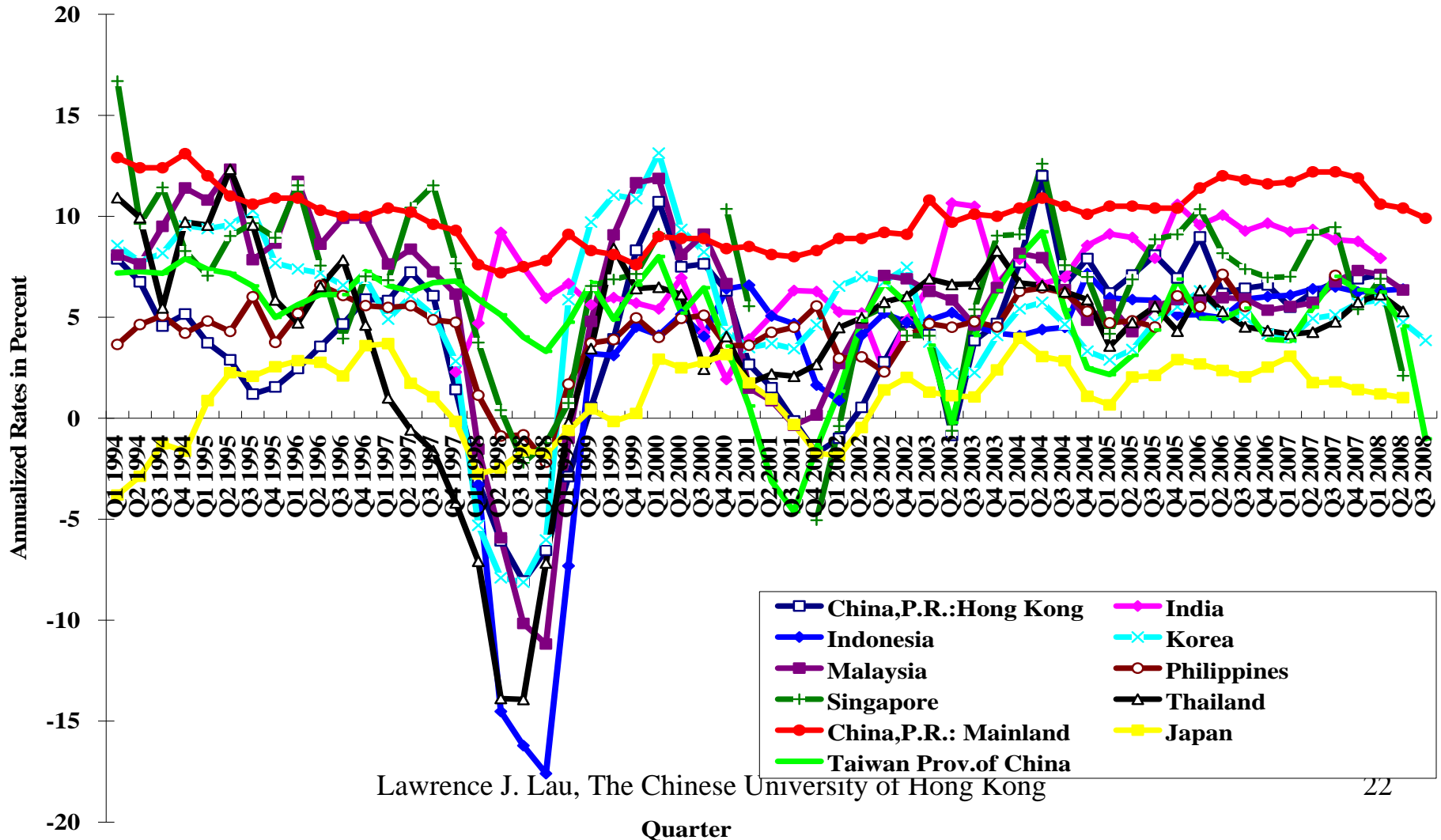
Quarterly Rates of Growth of Imports of Goods: Selected East Asian Economies

Figure 3.3: Year-over-Year Quarterly Rates of Growth of Imports of Goods in US\$ (Percent)



Quarterly Rates of Growth of Real GDP: Selected East Asian Economies

Figure 3.1: Quarterly Rates of Growth of Real GDP, Year-over-Year, Selected East Asian Economies



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Concluding Remarks

- ◆ The key question of long-term sustainable Chinese economic growth is on the demand side: what are sustainable sources of aggregate demand over the next decade or two? It will not be exports. It will have to be domestic demand, and I believe residential housing, education (and possibly health care), and urbanization and mass transit systems are all new sustainable sources of growth of domestic demand, in addition to public infrastructural investment and enterprise investment.