

Perspectives on the Chinese Economy

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Near-Term Outlook

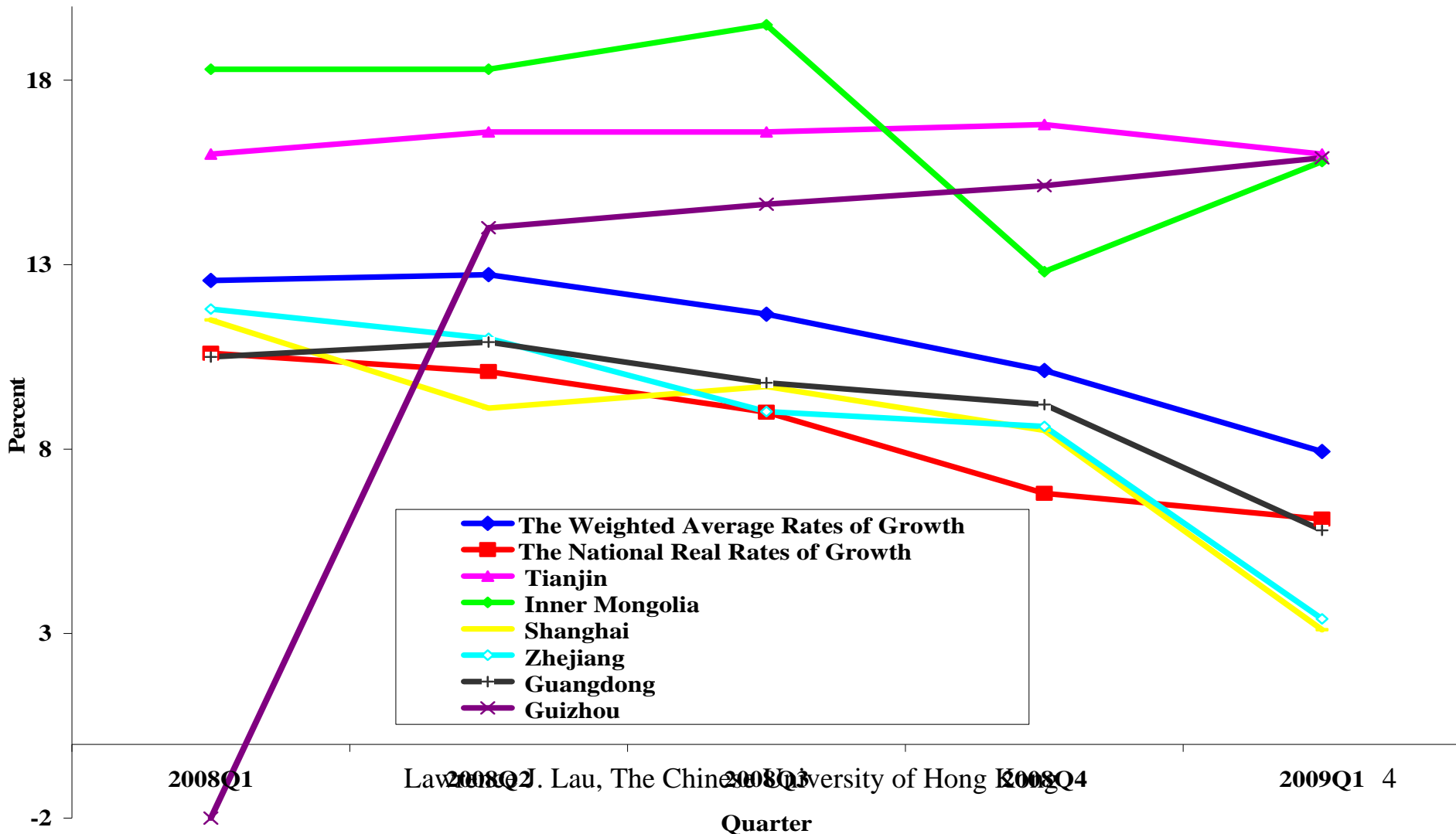
- ◆ The Chinese economy has essentially reached bottom in 2009Q1, with a rate of growth year-over year of 6.1 percent, following a rate of growth year-over-year of 6.8 percent in 2008Q4. The rate of growth is expected to increase in 2009Q2, by at least a couple of percentage points, due to the expected partial recovery in Chinese exports and the effect of the 4 trillion Yuan economic stimulus package over two years adopted in last November. As the economic stimulus package is gradually implemented, the rates of growth for the remaining quarters will either continue to increase or remain steady. Thus a whole-year rate of growth of between 7 and 8 percent is entirely feasible. Many forecasters have independently raised their projections for the rate of growth of Chinese GDP in 2009.

Provincial Economic Performance

- ◆ It is interesting to take note of the rates of growth of the individual provinces/regions/municipalities of China. The GDP-weighted averages of the provincial rates of growth for 2008Q4 and 2009Q1 are respectively 10.13 and 7.93 percent (higher than the National Bureau of Statistics figure of 6.8 and 6.1 percent, which is normal).
- ◆ Among the provinces, the three slowest growing ones in 2009Q1 are Shanxi (-8.1%), Shanghai (3.1%), and Zhejiang (3.4%). Shanxi, the principal coal-producing region of China, has been affected by the decline in both the price and the demand for coal. Shanghai and Zhejiang (the Yangzi River Delta region) are among the most externally oriented regions in China in terms of exports, arrivals of foreign direct investment, and arrivals of foreign tourists. So it is no surprise that they have been the hardest hit. However, even Guangdong (the Pearl River Delta), equally externally oriented, has been able to grow at 5.8 percent, slightly below the national average. The three fastest growing provinces/regions/municipalities in 2009Q1 are Tianjin (16%), Guizhou (15.9%), and Inner Mongolia₃ (15.8%), all at double-digit rates.

Quarterly Rates of Growth of Selected Chinese Provincial GDPs, Year-over-Year

Quarterly Rates of Growth of Provincial GDP, Year-over-Year

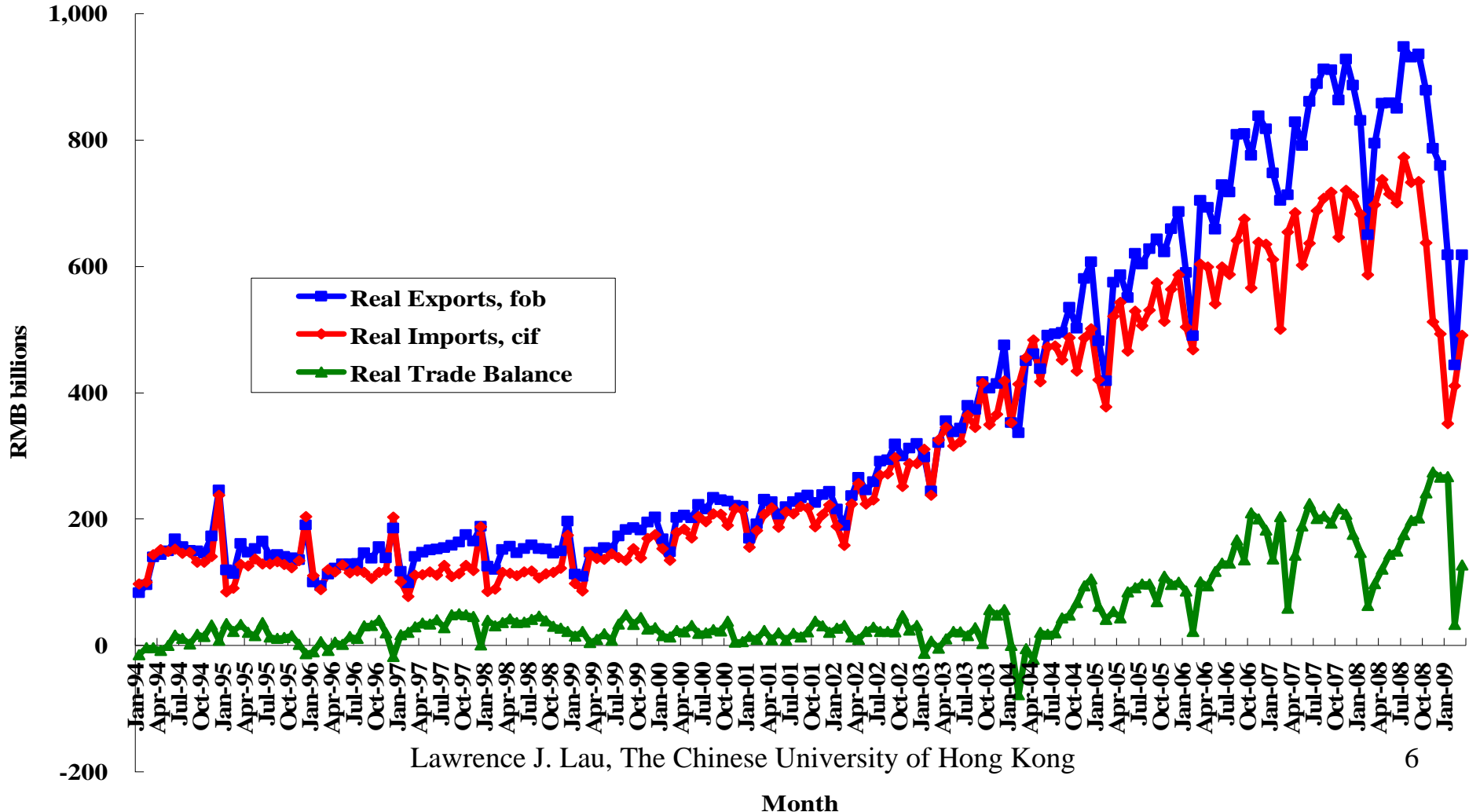


Export Dependence

- ◆ The export dependence of the Chinese economy is much less than it appears. A common misconception is that Chinese economic growth has been supported by large trade surpluses. This is not true. Chinese trade surplus vis-a-vis the World did not become significant until 2005 (long after the sub-prime loans have begun to pile up in the United States).

Chinese Monthly Real Exports, Imports and Trade Surplus (2008M12 prices)

The Real Level of Exports and Imports of Goods at the End of the Month, in RMB
(in 2008M12 prices)



Export Dependence

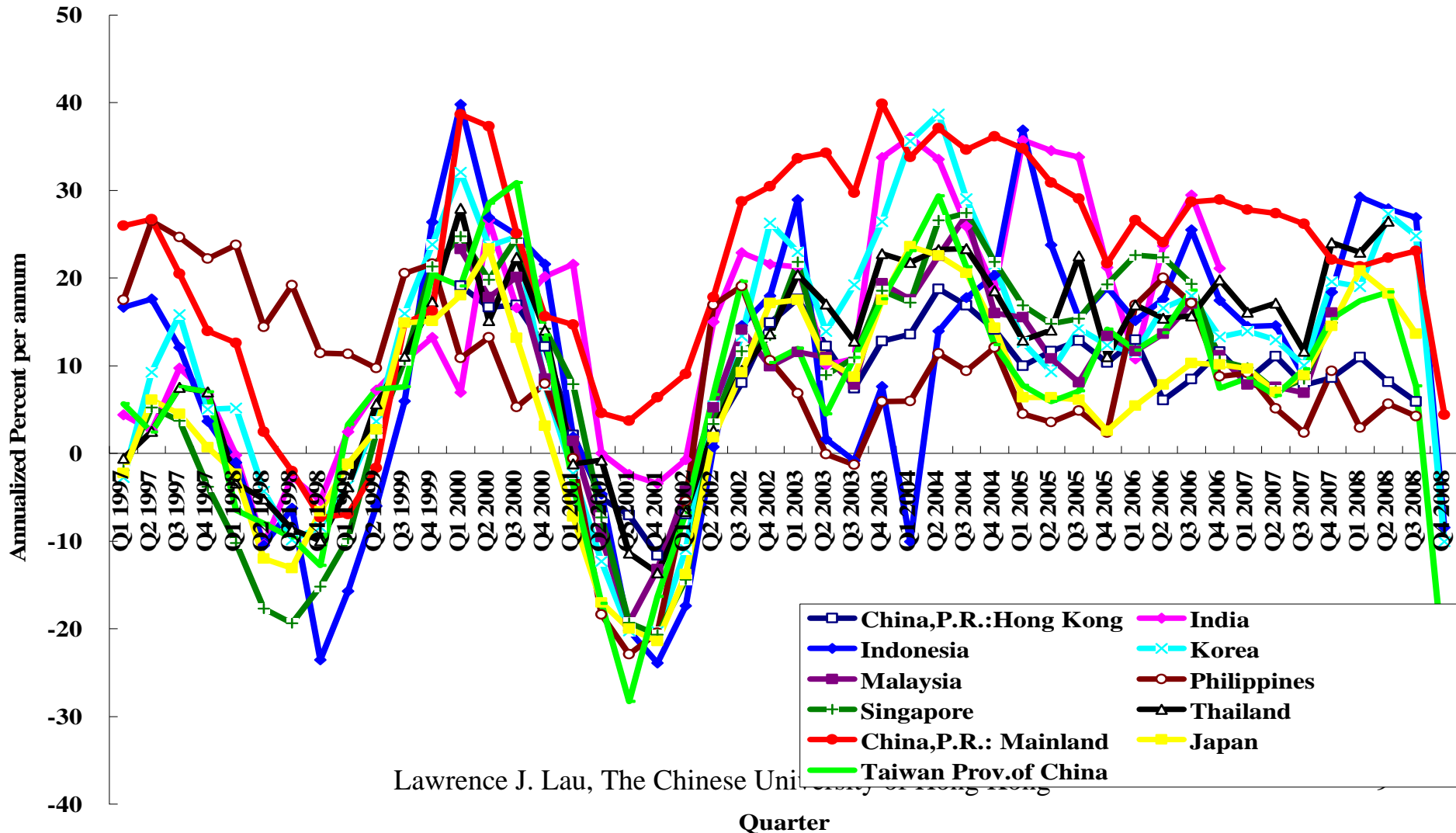
- ◆ Chinese exports as a percentage of Chinese GDP is somewhat less than 40 percent. However, the domestic value-added content of Chinese exports is only approximately 20 percent, that is, for every US\$ of Chinese exports to the world, only 20 cents are value-added in China itself—the rest consists of imported raw materials, intermediate goods, components, parts, semi-finished goods, etc. The domestic value-added percentage is even less for the so-called “Processing and Assembly” exports.
- ◆ If we multiply 40 percent by 20 percent, we obtain 8 percent, which is approximately the contribution of Chinese exports to Chinese GDP. 8 percent of GDP is a large number—no one wants to lose 8 percent of GDP--but if 8 percent of the GDP does not grow, and the remaining 92 percent manages to grow, the economy will do all right.

Export Dependence

- ◆ Even if exports decline by 25 percent, the rate of growth of real GDP will be reduced by approximately 25 percent of 8 percent, or 2 percentage points. So, for example, since the whole-year rate of growth of 2008 is 9 percent, a 25 percent decline in exports should result in a reduction of the rate of growth to 7 percent, other things being equal.
- ◆ An important implication of the relatively low export dependence of Chinese GDP is that the rate of growth of Chinese real GDP is relatively stable even as Chinese exports and imports fluctuate widely as the exports and imports of other East Asian economies.

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

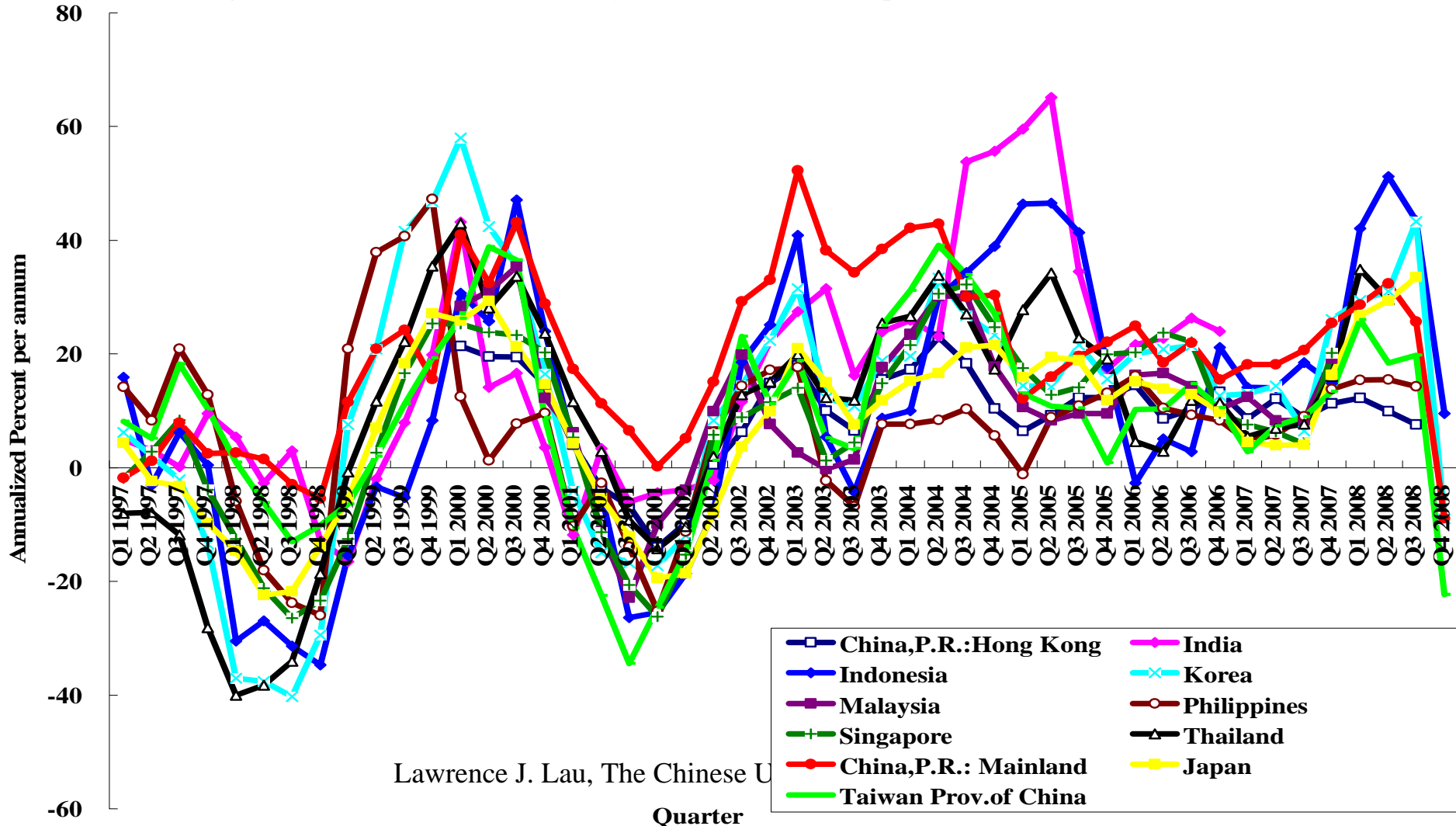
Figure 3.2: Year-over-Year Quarterly Rates of Growth of Exports of Goods in US\$ (Percent)



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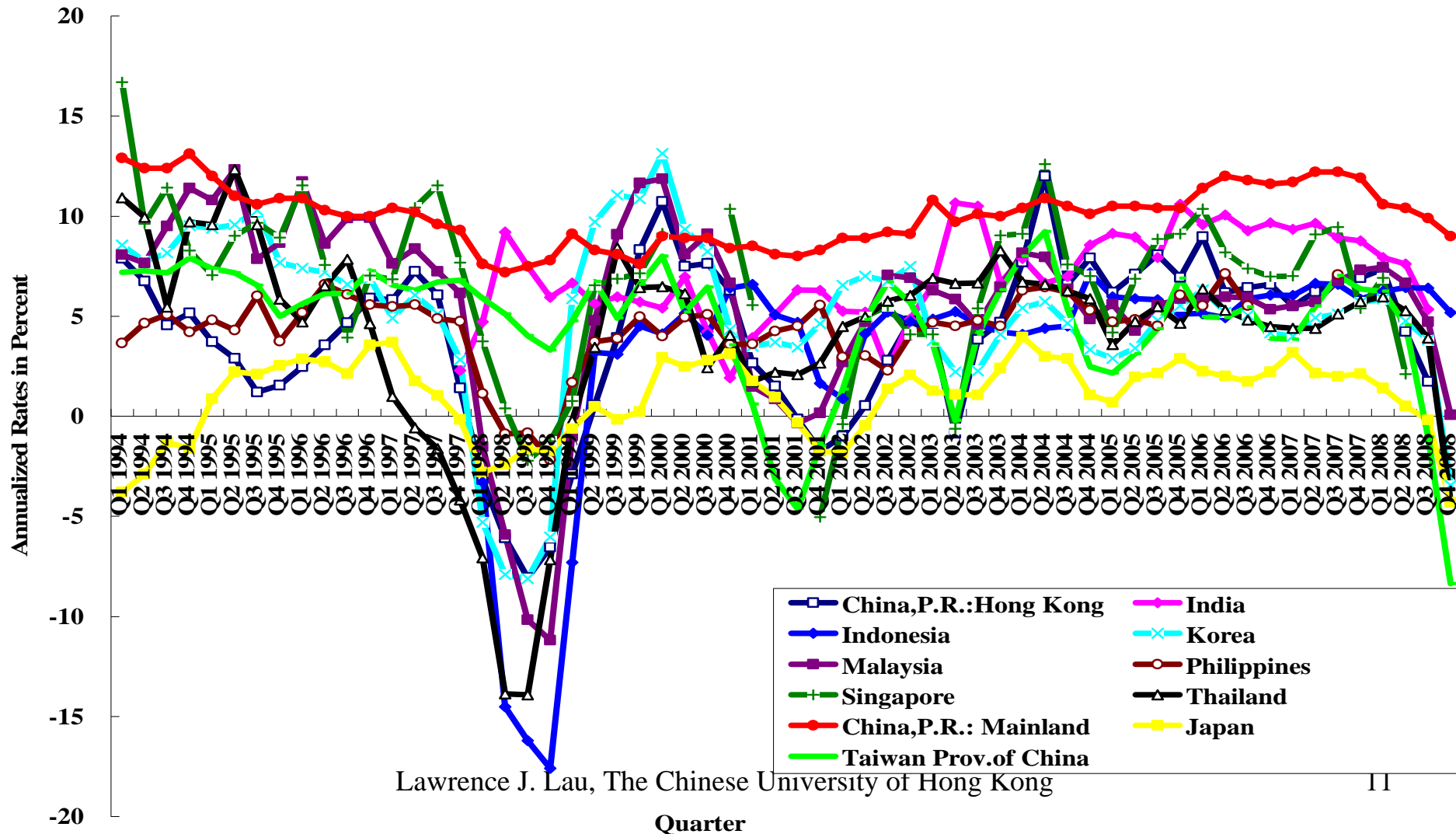
Quarterly Rates of Growth of Imports of Goods: Selected East Asian Economies

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



The Precipitous Decline of Export Orders

- ◆ The failure of Lehman Brothers in mid-September of 2008 caused bank credit to be completely frozen in the United States and in many parts of Europe, including the United Kingdom. It has meant that importers in these countries and regions can no longer have their banks issue letters of credit to exporters in the rest of the world, including East Asia and China. Moreover, it has also meant that importers will not have access to credit to finance their inventories. The result has been an immediate, precipitous reduction in the export orders, on the order of 50 percent compared to a year ago, received in East Asia and in China.

The Precipitous Decline of Export Orders

- ◆ However, it is important to realize that this reduction in export orders is primarily the result of a freeze in bank credit, as opposed to a reduction in the demand for imports, or the price of imports being too high (during this period, the US\$ has actually been appreciating or holding constant relative to East Asian currencies with the sole exception of the Japanese Yen). Even with the United States in recession, domestic personal consumption in 2009 is projected to decline by no more than 5 percent, and that should translate into a decline in import demand of at most 15 percent (or 3 times the decline in consumption). Moreover, imports from East Asia and China consist of predominantly low-end products, which should be relatively recession-proof (in fact, Wal-Mart sales have actually risen during this period). Thus, it is not possible for Chinese exports to be reduced by 50 percent permanently.

The Partial Recovery of Exports

- ◆ What has actually occurred is a postponement of the orders by the importers in the U.S. and elsewhere until they have the opportunity to work down their inventories and thereby raising cash.
- ◆ The East Asian and Chinese Governments have also been pro-actively promoting or providing seller (exporter)-financing of their exports. Now, two quarters later, East Asian and Chinese export orders are beginning to recover.

The Partial Recovery of Exports

- ◆ But it is unlikely that the East Asian and Chinese exports will recover to their previous peak levels. This is because demand for goods such as furniture, large-ticket items (consumer durable) such as refrigerators, washing machines, large-screen flat-panel television sets will have to await the recovery of the housing market. High-technology exports will also not recover quickly because in a recession both firms and households in the U.S. and other developed economies will postpone the replacement of personal computers, notebook computers and other information technology equipment until better times return. Thus, these industries will continue to face low export demands and must reorient themselves to serve the large and growing domestic consumption market.
- ◆ However, everyday consumption goods such as apparel and shoes will gradually recover and this recovery has been borne out by anecdotal evidence and by preliminary statistics on logistics, shipping and transportation.

The Chinese Economic Stimulus Package

- ◆ The Chinese Government has acted promptly and decisively in response to the global financial crisis and adopted a 4-trillion Yuan (over two years, equivalent to approximately 8 percent of GDP per year) economic stimulus package in November of last year. This has helped to maintain the confidence of both firms and households in China. As the effect of the economic stimulus package begins to be felt in 2009, the rate of growth should accelerate from its low of 6.1 percent in 2009Q1. Moreover, Premier WEN Jiabao of the People's Republic of China has committed to additional economic stimulus measures beyond the 4-trillion Yuan. Thus, an 8 percent rate of growth for the Chinese economy in 2009 and 2010 is entirely likely.

Long-Term Sustainable Sources of Growth of Chinese Aggregate Demand

- ◆ What is critical, however, is what comes after the complete implementation of the economic stimulus package in two years. There is a great deal of uncertainty as to whether the U.S. economy has reached bottom, and even if it has, there is also a great deal of uncertainty as to whether and when it will resume growing, as opposed to just holding steady. In order for the Chinese economy to continue to grow, independently of the speed of economic recovery in the U.S. and elsewhere, China must look for sources of sustainable growth in its own domestic aggregate demand, and not in exports.
- ◆ There are at least four possible areas of growth for Chinese aggregate demand: owner-occupied residential housing for middle and lower-middle income households; upgrading the national information and communication infrastructure; accelerated urbanisation, especially in the currently rural areas, and institution of urban planning and promotion of mass transit systems; and promotion of a green economy (energy-efficient and environmentally friendly).

A Role for China Development Bank

- ◆ In order to promote the owner-occupied residential housing sector in China (and also in support of accelerated urbanisation), it is necessary to have long-term (say 35 years), fixed-interest-rate mortgage loans, which lower the monthly payments and eliminate the interest-rate risk for middle and lower-middle income households.
- ◆ It is risky for commercial banks, with only short-term deposits at variable interest rates, to offer such long-term fixed-interest-rate mortgage loans.

A Role for China Development Bank

- ◆ A policy bank can fulfill a useful function by selling long-term, fixed-interest-rate bonds to insurance companies and pension funds and using the proceeds to purchase qualified, owner-occupied residential mortgage loans from the originating commercial banks (with a partial holdback for say three years). Note that this does not necessarily entail securitisation of the mortgage loans.
- ◆ Since a policy bank can borrow at lower interest rates based on its sovereign or quasi-sovereign credit, the fixed interest rate may in fact turn out to be lower than any interest rate the commercial banks can offer for this type of qualified, owner-occupied residential mortgage loans (which is even better for the promotion of the housing sector).
- ◆ China Development Bank Corporation is ideally suited to enter this new line of business of providing long-term finance.