

# **FIVE CHALLENGES THAT CHINA MUST OVERCOME TO SUSTAIN ECONOMIC GROWTH**



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**Joint Economic Committee  
United States Congress**

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## **Executive Summary**

Although the Chinese economy is booming, the People's Republic of China (PRC) faces five major challenges to sustain rapid economic growth in the future:

- unfavorable demographics;
- corruption and a weak rule of law;
- financially distressed state-owned enterprises and state-influenced enterprises;
- a dysfunctional financial system; and
- domestic and international imbalances.

The PRC's response to these challenges will, of course, determine the future performance of the Chinese economy. However, since the Chinese economy is so large and well integrated into the global economy, the performance of the Chinese economy will also affect the performance of the United States and other economies in the world.

So far, the PRC's approach to reform has been incremental. This incremental approach may be reaching the limits of its effectiveness. The challenges that the PRC now confronts are deeply interrelated. A more comprehensive approach to reform is needed.

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# **FIVE CHALLENGES THAT CHINA MUST OVERCOME TO SUSTAIN ECONOMIC GROWTH**

## **I. INTRODUCTION**

Since 1979, reform has transformed the People's Republic of China (PRC) from an impoverished autarkic socialist economy into a vibrant mixed economy that is open to international trade and investment. This study describes the genesis of economic reform under Paramount Leader Deng Xiaoping from 1979 to 1992 and reviews the subsequent performance of the Chinese economy.

Despite its success, the PRC confronts five serious challenges that it must overcome to sustain rapid economic growth in the future:

- unfavorable demographics;
- corruption and a weak rule of law;
- financially distressed state-owned enterprises (SOEs) and state-influenced enterprises (SIEs);
- a dysfunctional financial system; and
- domestic and international imbalances.

The PRC's response to these challenges will, of course, determine the future performance of the Chinese economy. However, since the Chinese economy is so large and well integrated into the global economy, the performance of the Chinese economy will also affect the performance of the United States and other economies throughout the world.

So far, the PRC's approach to reform has been incremental. This study concludes that this incremental approach may be reaching the limits of its effectiveness. The economic challenges that the PRC now faces are deeply interrelated. A more comprehensive approach to reform is needed.

## **II. GENESIS OF ECONOMIC REFORM**

Between 1979 and 1992, the Communist Party of China (CPC) lost its political legitimacy. The excesses of the Cultural Revolution repulsed the Chinese people and eroded their belief in communism as an ideology.<sup>1</sup> The contrast between the rapid development of the Japanese, South Korean, and other market-oriented economies in northeast and southeast Asia and the lack of development in the Chinese economy demonstrated the failure of communism as an economic system. Finally, the fall of the Berlin Wall in 1989 and the dissolution of the Soviet Union in 1991 undermined their confidence in communism as a political system.

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<sup>1</sup> On May 16, 1966, Chairman Mao Zedong launched the Great Proletarian Cultural Revolution to regain some of the political power that he had lost to CPC rivals after the economic disaster of the Great Leap Forward. During the next two years, Mao's wife, Jiang Qing, and other supporters organized the Red Guards to seize control of party organizations and government organs. Because of this power struggle, millions of Chinese died, were imprisoned, or were injured. Although Mao officially terminated the Cultural Revolution in 1969, historians date the end of the Cultural Revolution to the arrest of the Gang of Four (i.e., Jiang Qing and three of her associates, Zhang Chunqiao, Yao Wenyuan, and Wang Hongwen) in 1976.

Paramount Leader Deng Xiaoping was determined to preserve the communist regime in the PRC. After careful study, Deng identified several policy errors that contributed to the failure of the Soviet Union and its satellites:

- The Soviet economy could not sustain the costs of the Soviet Union's global military confrontation with the United States during the Cold War.
- The liberalization of the political system in Soviet Union and its satellites before economic reforms could produce prosperity allowed dissatisfied electorates to vote the communists out of power.

To regain political legitimacy, Deng decided that the CPC must transform its image, so that the Chinese people would perceive the CPC as the provider of their economic prosperity. Deng realized that an autarkic socialist economy could not deliver prosperity. Therefore, Deng concluded that the PRC had to adopt market-oriented economic policies and institutions and open itself to international trade and investment.

While immediate and sweeping policy changes would have sped the transformation of the PRC into a market economy, a "big bang" approach to reform would have also caused severe short-term dislocations during the transition. Unlike the former Soviet satellites, the CPC could have not blamed these transition costs on a previous regime. Moreover, any overt rejection of communism may have triggered a coup attempt among hardliners within the CPC.

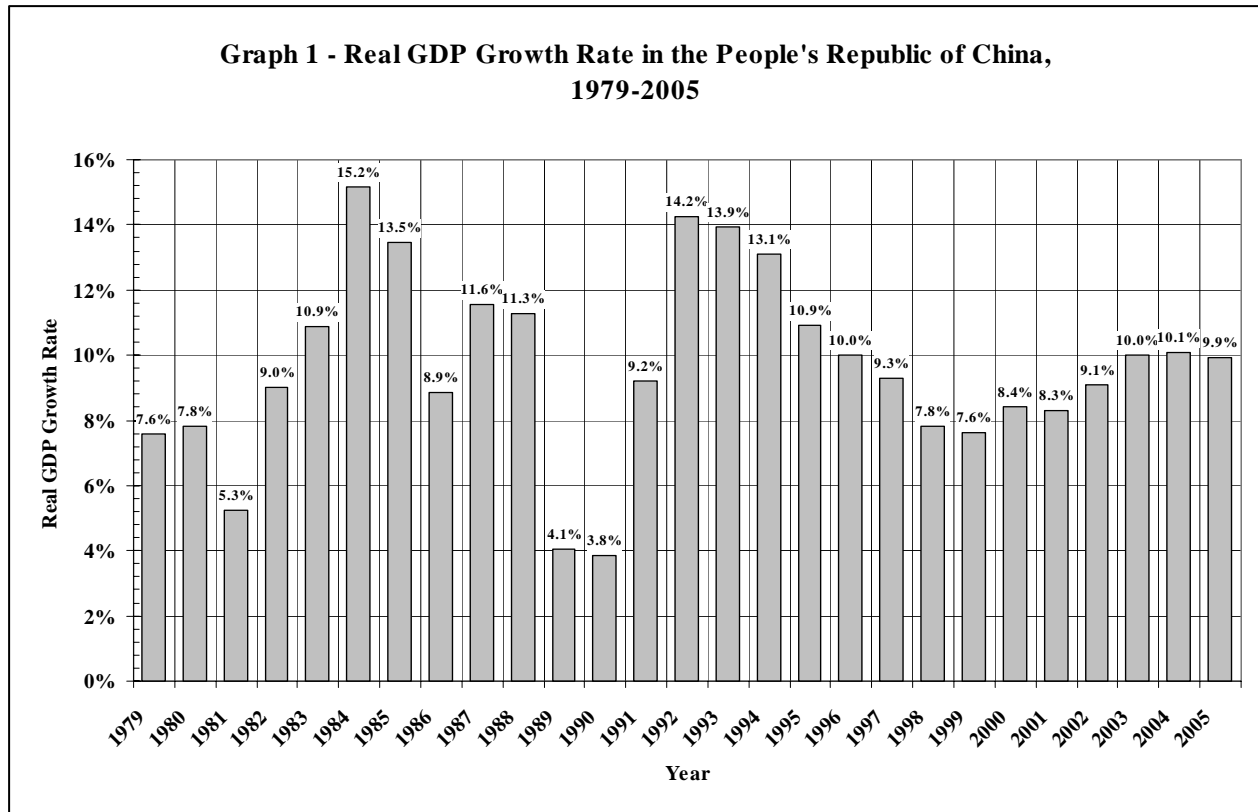
Therefore, Deng decided to introduce economic policy changes gradually. Experiments were to be conducted in special economic zones, revised on the basis of results, and then adopted throughout the PRC. This incremental approach to reform would allow the CPC leadership sufficient time to isolate and neutralize opponents and to redefine communism. Indeed, the CPC has subsequently displayed remarkable ideological flexibility (e.g., describing market economics as socialism with Chinese characteristics).

During his trip to southern China during the spring of 1992, Deng proclaimed a "bargain" that still guides the PRC today:

- Domestically, the PRC would liberalize the economy to provide prosperity to the Chinese people, while the PRC would suppress political dissent.
- Internationally, the PRC would pursue "peaceful development" by:
  - opening itself to international trade and investment;
  - being a "good neighbor" in Asia;
  - avoiding direct military confrontations with the United States; and
  - securing access to oil and other natural resources even if the PRC must deal with rogue regimes.

The PRC rejected the failed import-substitution development strategies that India and Latin America had pursued in the 1970s and 1980s and instead copied the successful export-promotion development strategies of the Japanese, South Korean, and other economies in northeast and southeast Asia. The PRC relied on exports and foreign direct investment to:

- introduce the price system;
- correctly align domestic incentives; and



- import needed management skills and technology.

The PRC sought to exploit its comparative advantage in abundant low-cost labor with:

- labor-intensive manufacturing of low-tech goods (e.g., apparel, footwear, sporting goods, and toys) for export; and
- labor-intensive final assembly of medium-tech consumer electronics and information technology products from imported parts for export.

### III. RESULTS OF ECONOMIC REFORM

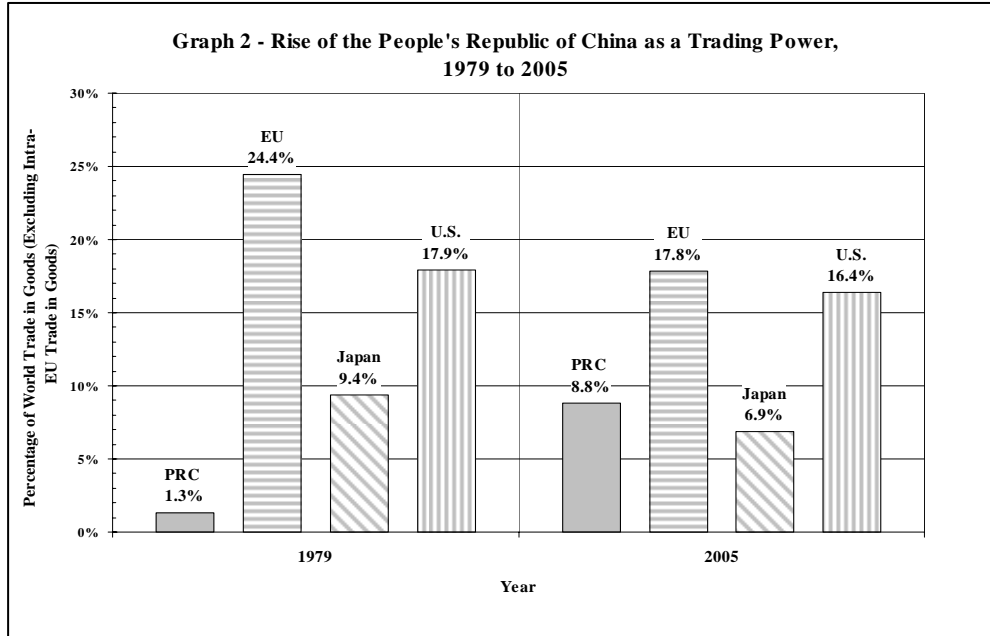
Reform has boosted the PRC's economy and improved the living standards of its people. Real GDP growth averaged 9.7 percent from 1979 to 2005 (see Graph 1).<sup>2</sup> In the first half of 2006, the Chinese economy grew at an annualized rate of 10.9 percent. This growth has lifted 400 million Chinese out of poverty.<sup>3</sup>

Reform has made the PRC a major trading power. In 1979, the PRC accounted for 1.3 percent of the world's two-way trade in goods (see Graph 2).<sup>4</sup> Real growth in the PRC's two-

<sup>2</sup> China National Bureau of Statistics/Haver Analytics.

<sup>3</sup> [U]sing the World Bank's \$1 per day income standard, the number of poor is estimated to have dropped from about 490 million to 88 million over the same period, a decline in poverty incidence from 49 percent in 1981 to 6.9 percent in 2002. World Bank, *Shanghai Poverty Conference: Case Study Summary* (2004).

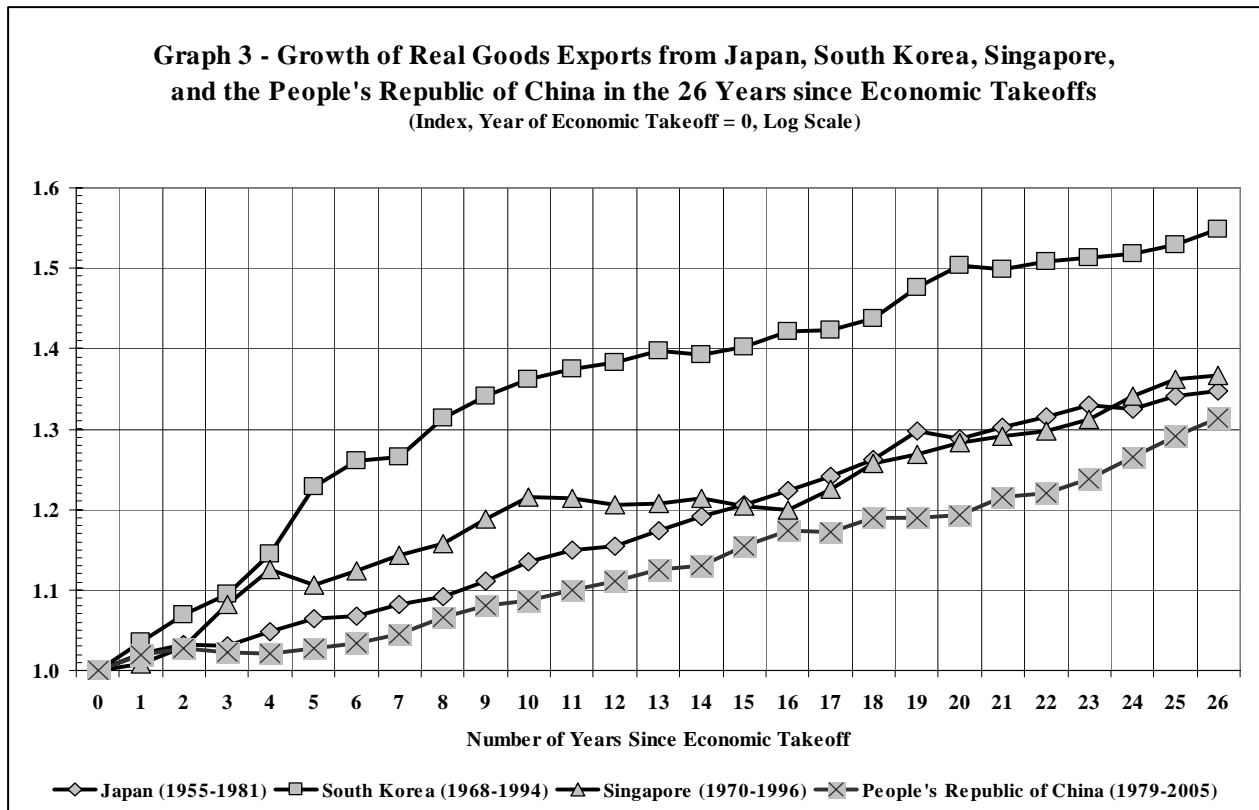
<sup>4</sup> Excludes intra-European Union goods trade. Author's calculation based on International Monetary Fund/Haver Analytics data.



way trade in goods averaged 13.7 percent from 1979 to 2005.<sup>5</sup> By 2005, the PRC accounted for 8.8 percent of the world's two-way trade in goods (see Graph 2).<sup>6</sup>

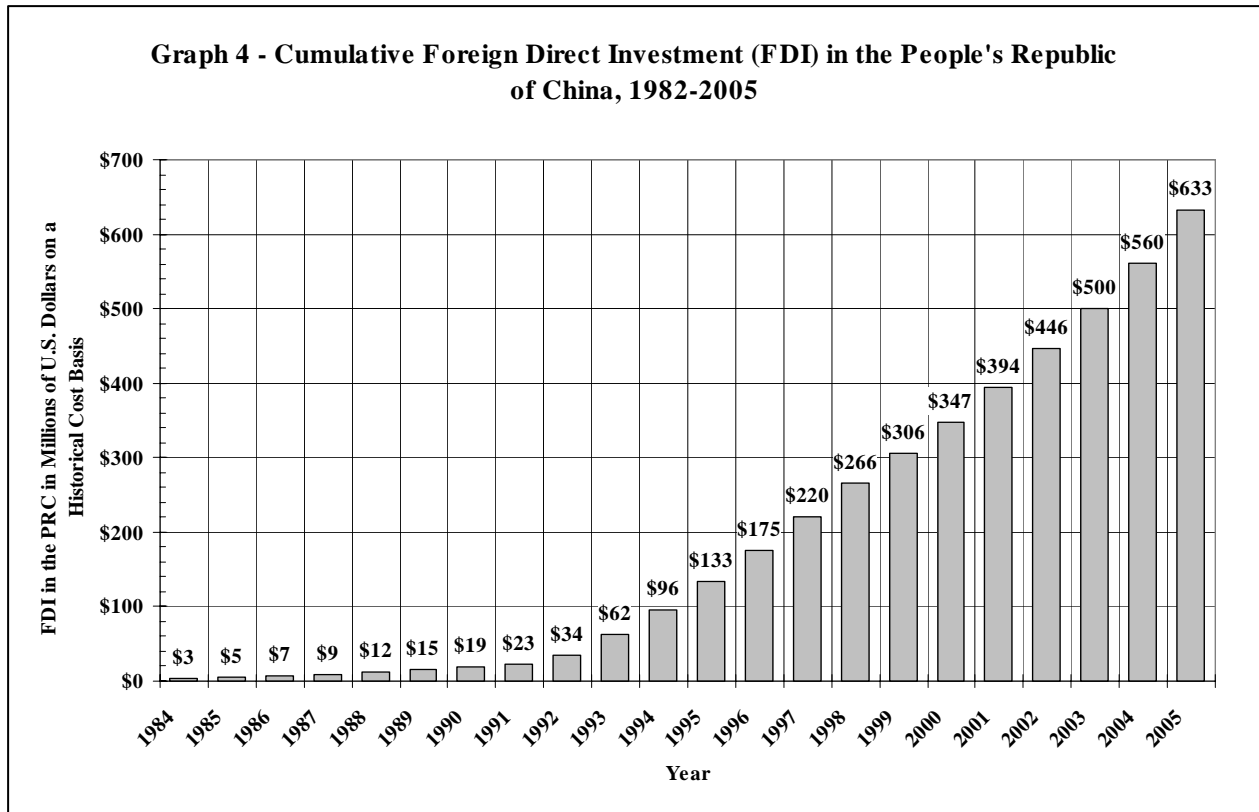
While the PRC's trade performance may seem outstanding, it is actually quite typical for

economies in northeast and southeast Asia that followed an export-promotion development strategy. During the twenty-six years after the takeoff of their economies, Japan, South Korea, and Singapore had similar or better trade performances than the PRC (see Graph 3).<sup>7</sup>



<sup>5</sup> International Monetary Fund/Haver Analytics.

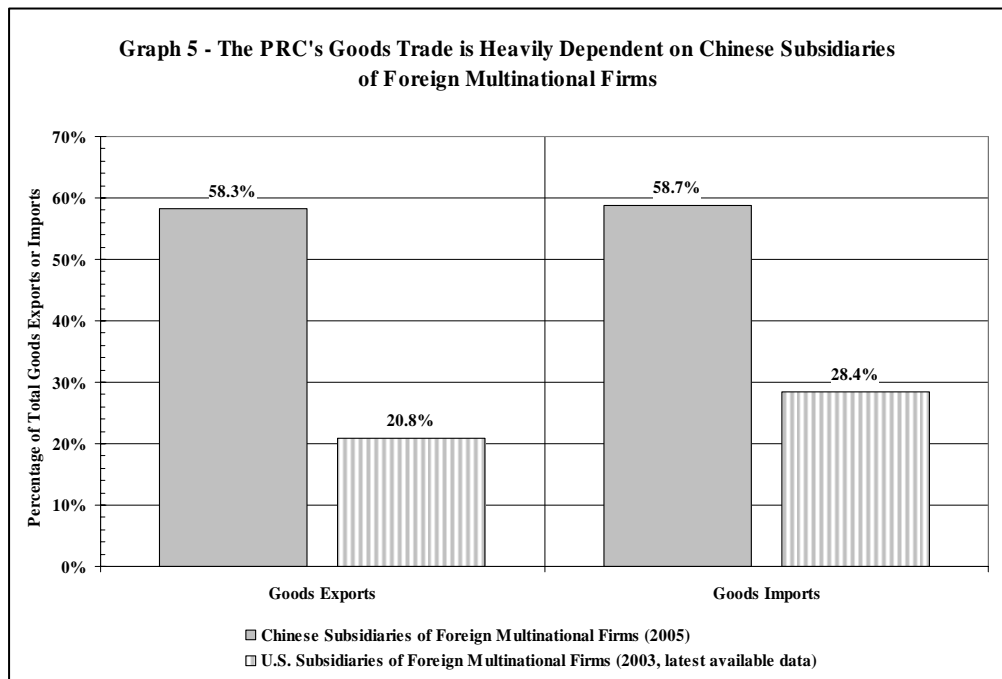
<sup>6</sup> Excludes intra-European Union goods trade. Author's calculation based on International Monetary Fund/Haver Analytics data.



The PRC's heavy reliance on foreign direct investment (FDI) distinguishes its

development strategy and its post-takeoff performance from other populous economies in northeast and southeast Asia.<sup>8</sup> From 1979 to 2005, the PRC received a cumulative \$633 billion of FDI on a historical cost basis (see Graph 4).<sup>9</sup>

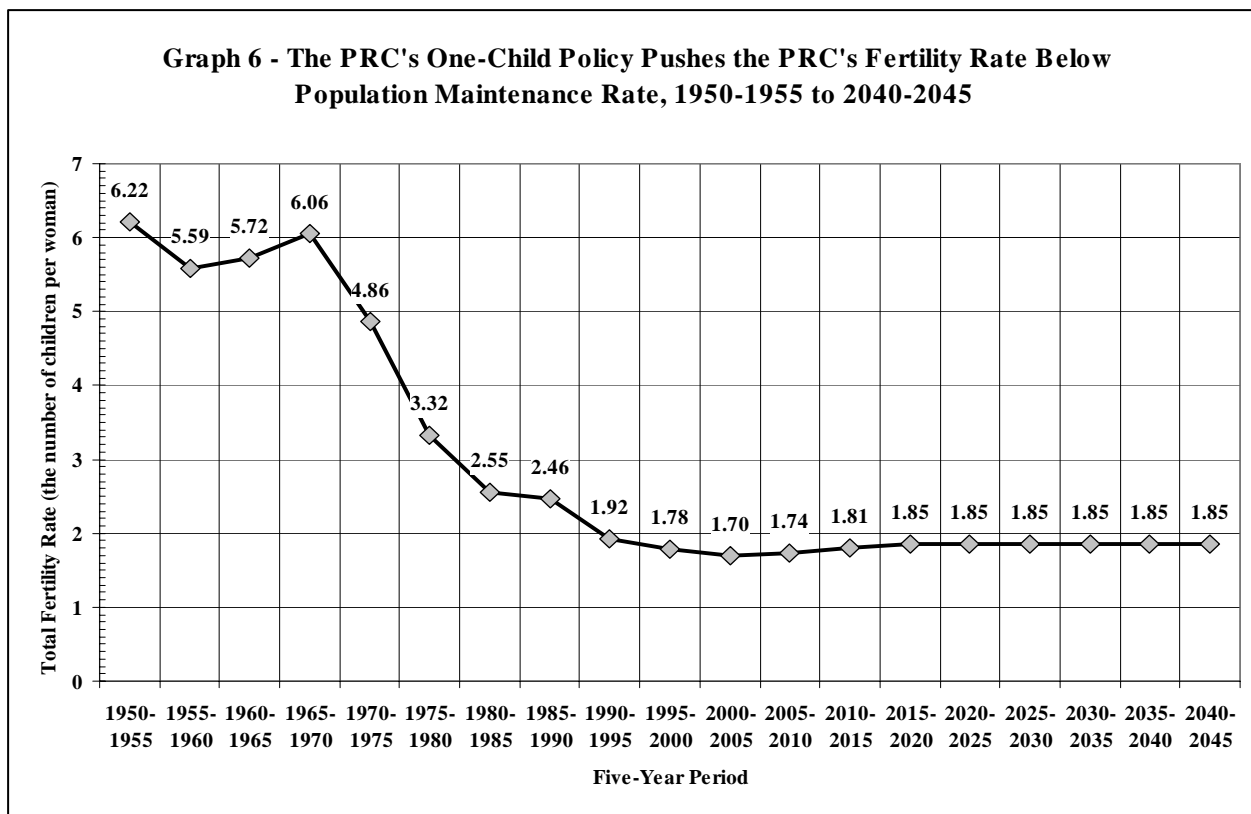
The Chinese



<sup>7</sup> Author's calculation based on International Monetary Fund/Haver Analytics data.

<sup>8</sup> The "city-state" economies of Hong Kong and Singapore are also heavily reliant on foreign direct investment.

<sup>9</sup> China National Bureau of Statistics/Haver Analytics.



subsidiaries of foreign multinational firms produced 19.1 percent of the PRC’s value-added for industrial firms in 2003 (the last year in which comprehensive firm-level data are available)<sup>10</sup> and accounted for 58.3 percent of the PRC’s exports of goods and 58.7 percent of its imports of goods in 2005 (see Graph 5).<sup>11</sup> Unlike Japan or South Korea twenty-six years after the takeoff of their economies, the PRC has spawned relatively few Chinese multinational firms that manufacture own-design, own-brand goods for global markets.

**IV. UNFAVORABLE DEMOGRAPHICS**

The first challenge that the PRC must overcome is unfavorable demographics. Without significant immigration, the PRC’s declining fertility rate will cause its working-age population to peak in 2015 and then decline. Simultaneously, the PRC’s increasing longevity rate will swell both the number of the elderly and the elderly as a percentage of total population.

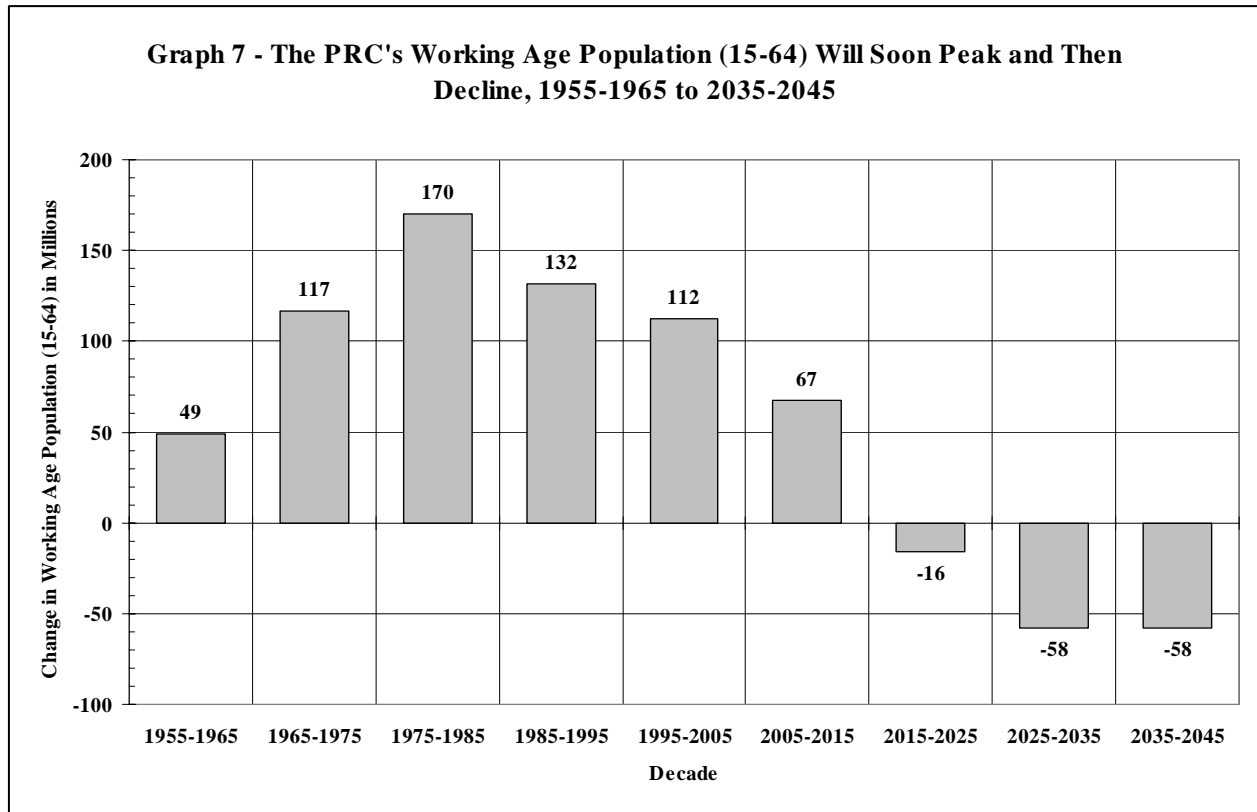
**A. Declining Labor Force**

Because of the PRC’s one-child policy and rising per capita income, the PRC’s fertility rate fell to 1.70 per woman during 2000-2005 -- well below the population maintenance rate (see Graph 6). Consequently, the PRC’s working-age population (ages 15-64) will peak in 2015 and then begin to shrink (see Graph 7).<sup>12</sup>

<sup>10</sup> *OECD Economic Survey: China* (Paris: Organization for Economic Cooperation and Development, 2005): 133.

<sup>11</sup> China National Bureau of Statistics/Haver Analytics.

<sup>12</sup> United Nations Population Division, *World Populations Prospects: The 2004 Revision Population Database*, <http://esa.un.org/unpp/p2k0data.asp>.



In major cities, the economic boom has already created a shortage of highly skilled workers and professionals, boosting their real compensation. The *Financial Times* recently reported:

*“Five years ago, to employ an engineer in China cost a tenth of the figure in the U.S.,” says Michael Marks, chairman of Flextronics, a U.S.-listed company that is the world's second biggest contract manufacturer for the electronics industry. “Today the difference is only half.”<sup>13</sup>*

Real compensation for less skilled or unskilled workers has also begun to grow, but at a slower pace. Because of higher labor costs, the “China price” – the price that major retailers (e.g., Walmart, Carefour) are willing to pay to their suppliers based on the cost of importing similar goods from China – increased for the first time in 2005.<sup>14</sup>

Currently, the PRC has a “floating population” of about 140 million unemployed or underemployed people. At the PRC’s current growth rate, however, these “floaters” will be fully absorbed into the economy by 2015.

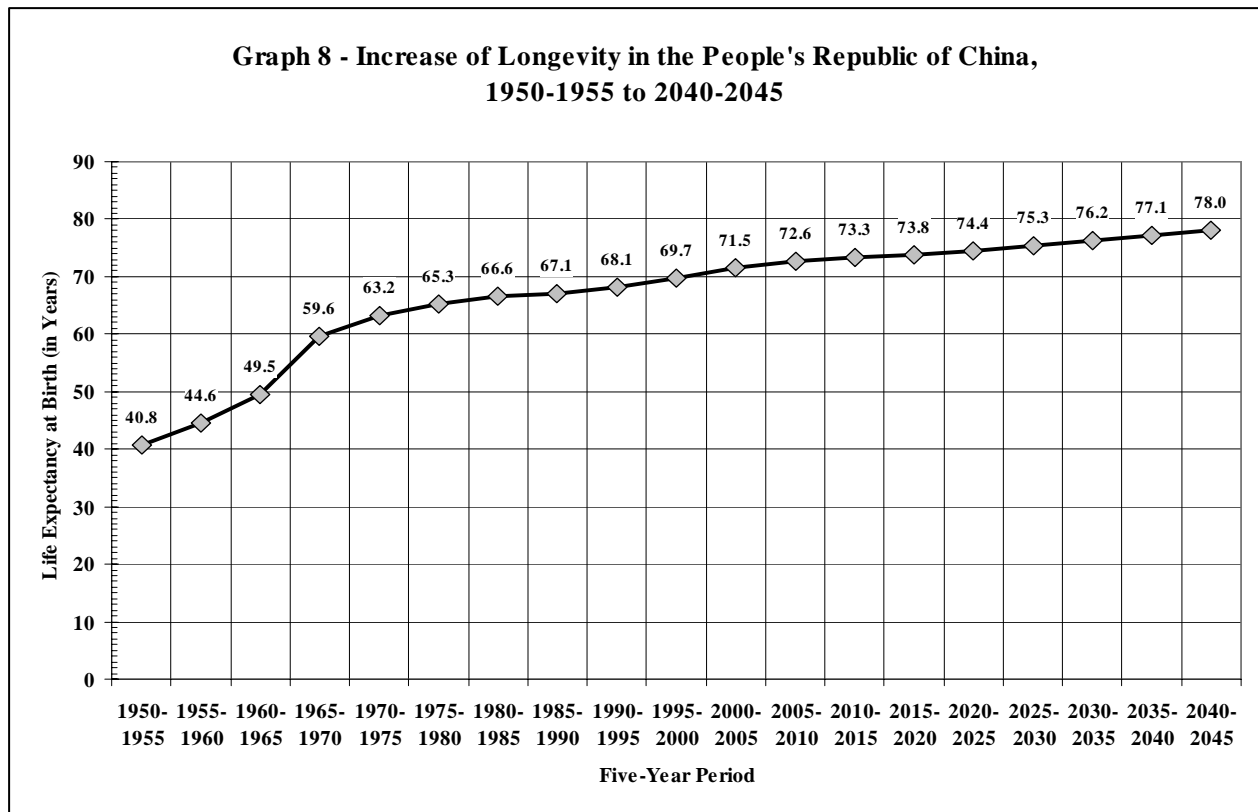
Consequently, the PRC cannot remain a low-wage economy. After 2015, labor shortages should significantly increase the real compensation of all Chinese workers. This will force the PRC to shed many of its current jobs in labor-intensive industries and assembly operations. To foster continued economic growth, the PRC will need to climb the “development ladder” by

- encouraging Chinese firms to develop their own brands and designs;

<sup>13</sup> Peter Marsh, “Foreign Makers Find Advantages on More Familiar Turf,” *Financial Times* (May 7, 2006).

<sup>14</sup> Tom Mitchell, “How China is Handling Cost Rises by Boosting Value,” *Financial Times* (May 7, 2006).





- switching from labor-intensive to capital-intensive manufacturing; and
- expanding the service sector.

### **B. Graying Population.**

Higher living standards have boosted the PRC's life expectancy at birth to 71.5 years during 2000-05 (see Graph 8).<sup>15</sup> Since the increase in longevity is expected to continue, the PRC's elderly population should increase from 100 million, or 7.6 percent of the total population, to 320 million, or 23.0 percent of the total population, in 2045.<sup>16</sup> Consequently, the elderly support ratio (i.e., the ratio of elderly Chinese to working-age Chinese) is expected to drop from 9.3 in 2005 to 2.7 in 2045 (see Graph 9).<sup>17</sup>

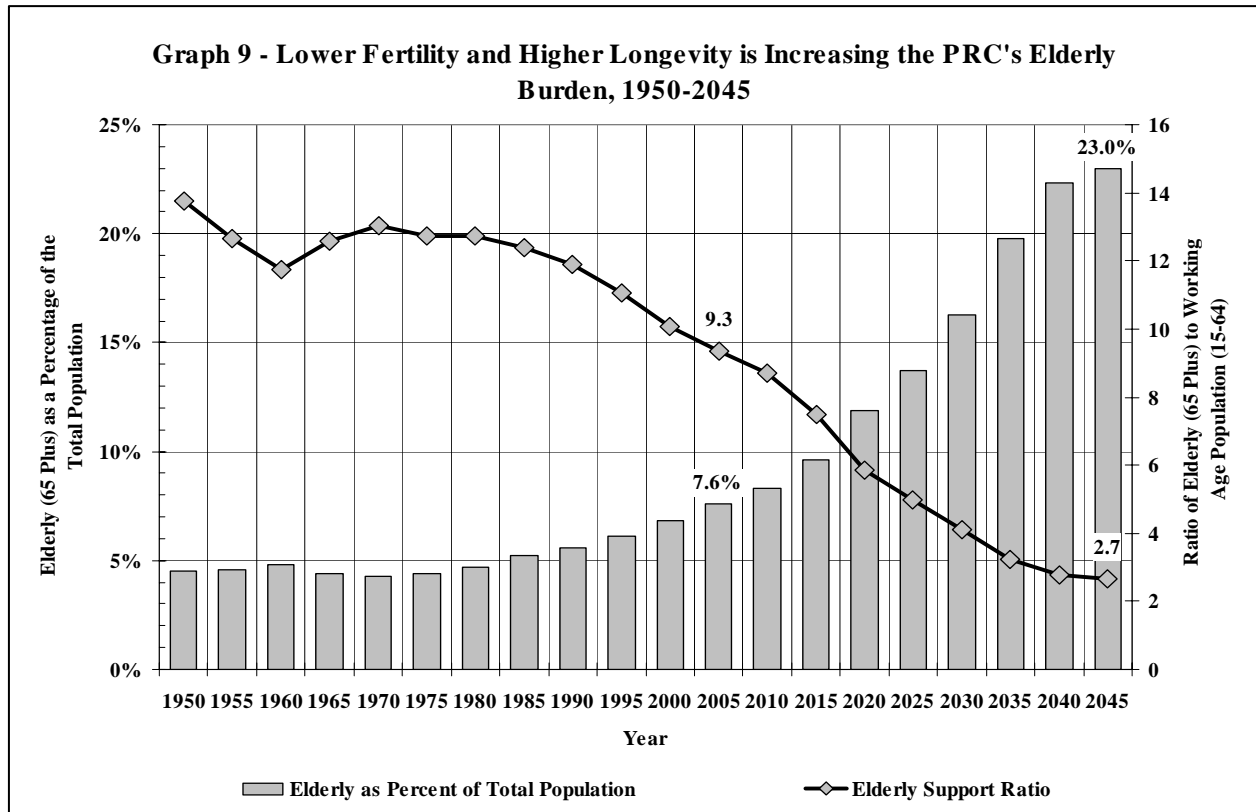
Unlike other major economies, the PRC lacks a comprehensive system of either government old-age pensions or private retirement saving plans. Reform eliminated Mao's "iron rice bowl" system under which state-owned enterprises provided their workers with comprehensive social-welfare benefits. Today, only 15 percent of urban workers are eligible for government old-age pensions.<sup>18</sup> Few private retirement plans are available. Consequently, the elderly must rely on their own savings or their family for retirement income.

<sup>15</sup> United Nations Population Division, *World Populations Prospects: The 2004 Revision Population Database* (2004). Found at: <http://esa.un.org/unpp/p2k0data.asp>.

<sup>16</sup> Author's calculation based on the United Nations Population Division data.

<sup>17</sup> Ibid.

<sup>18</sup> The PRC has a pay-as-you-go defined benefit old-age pension plan for urban workers in the formal sector. Employers pay a payroll tax equal to 20 percent of an employee's base wage or salary. Covered employees are eligible for an old-age pension of 20 percent of the average wage in their locality after (1) completing fifteen years

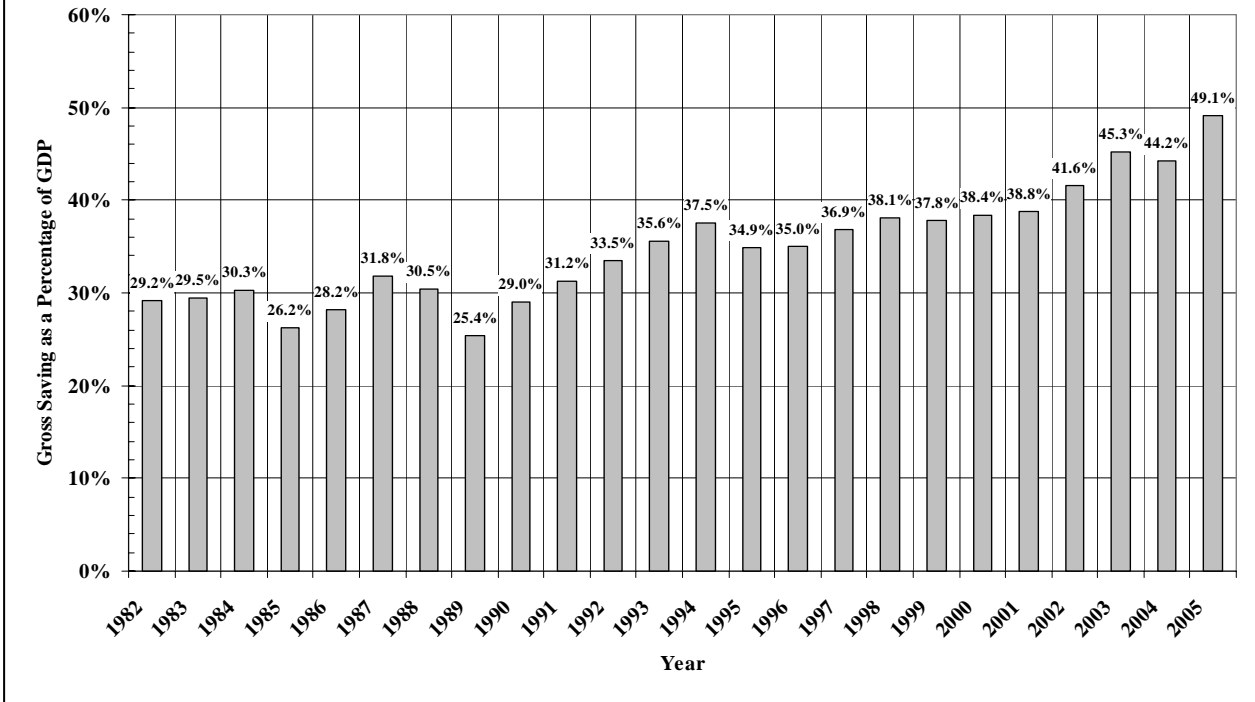


The lack of a government social safety net and the limited availability of consumer credit, insurance products, and private retirement plans drive Chinese households to save prodigious sums. In 2005, the PRC’s gross saving rate was 49.1 percent of GDP (see Graph 10).<sup>19</sup> The PRC’s gross saving rate is extraordinarily high compared to other major economies (see Graph 11). Until the PRC develops a comprehensive social safety net and deepens its market for financial services, Chinese households are unlikely to reduce their extraordinarily high saving rate. Consequently, the PRC may incur difficulties shifting from export-led to domestic consumption-driven economic growth.

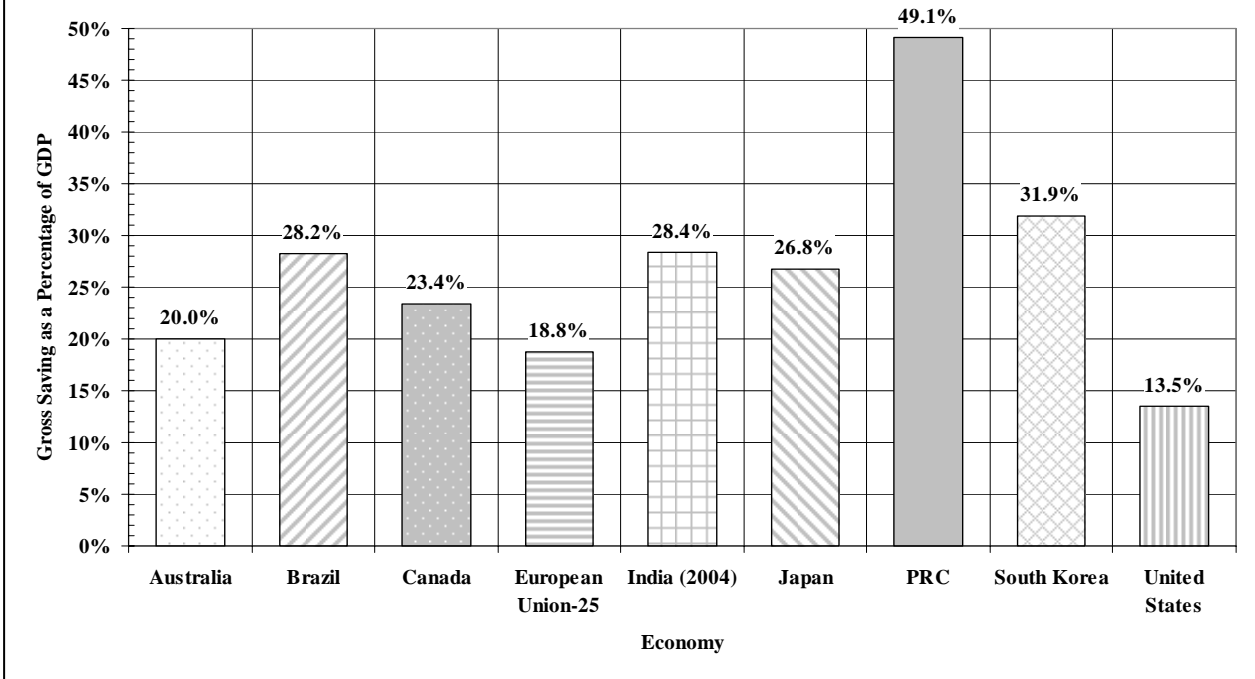
of service and (2) reaching the age of 60 for men, 50 for woman in manual labor, and 55 for other women. In addition, employees must contribute an additional 8 percent of their base wage or salary to defined contribution plans, of which 5 percentage points goes to a government notional plan and 3 percentage points goes to individual accounts. Upon retirement, annuity payments from the government notional plan are based an employee’s notional balance divided by 120. Urban workers in the informal sector, rural workers, and self-employed individuals are not eligible for any of these plans.

<sup>19</sup> Author’s calculation based upon data from China National Bureau of Statistics/Haver Analytics.

**Graph 10 - Gross Saving Rate in the People's Republic of China, 1982-2005**



**Graph 11 - The PRC's Gross Saving Rate is Unusually High Compared to Other Major Economies, 2005**



## V. CORRUPTION AND A WEAK RULE OF LAW

The PRC has adopted a “rule by law,” but still lacks a “rule of law.” Although there have been significant procedural improvements in the drafting of legislation,<sup>20</sup> many Chinese laws and regulations still lack clarity, their enforcement may be arbitrary, and courts are subject to political influence. Consequently, property rights are insecure.

Individuals and private firms must rely on *guanxi* (i.e., connections) with officials to protect themselves and their property. During the last quarter century, economic reform has produced a *de facto* political decentralization that has allowed officials to exploit their *guanxi* to enrich themselves and their families through corruption.

While the PRC is nominally a unitary state, it has many levels of subsidiary government – provinces, prefectures, cities, counties, towns, and villages. The central government is quite small, employing about 500,000 of the estimated 36 million working in governmental functions.<sup>21</sup>

The PRC’s government is organized as a matrix. Each department in the central government is paired with similar departments in subsidiary governments. Policy is vertical (i.e., the heads of central government departments in Beijing determine policy and direct its implementation through similar departments in subsidiary governments), but administration is horizontal (i.e., the heads of subsidiary governments make personnel decisions and fund the operations of all departments in their subsidiaries).

Under Mao, the PRC’s government functioned as a hierarchal structure since the central government tightly controlled the economy. Reform has allowed local party leaders to acquire great wealth through legitimate business investments and various corrupt payments. Both legitimate tax receipts from a booming economy and corrupt payments have also reduced the financial dependency of subsidiary governments on central government transfers. Together these changes have limited the central government’s ability to implement policy changes and control corrupt practices. Employees in local departments may have greater loyalty to local government officials and party leaders than to department heads in Beijing. The Chinese use an old proverb to describe this problem, “The mountain is high, and the emperor is far away.”

Corruption is both widespread and costly in the PRC. Transparency International reported that the PRC scored 3.2 on its *Corruption Perceptions Index 2005* (10 is corruption-free).<sup>22</sup> Chinese economist Angang Hu<sup>23</sup> estimated that corruption costs the PRC’s government an amount to equal 15 percent of GDP in lost revenue and skimmed funds.<sup>24</sup> The *China Economic Quarterly* (2005) reported that provincial and local government officials extracted the equivalent of 91 percent of the profits of private firms in 2003 through non-tax costs, including fees, *tanpai* (i.e., forced expenditures on unwanted provincial or local goods or services), or *zhaodai* (i.e., the entertainment of provincial or local government officials).<sup>25</sup>

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<sup>20</sup> Central and subsidiary governments now publish proposed laws and regulations and provide time for public comments before enactment. Public hearings have caused officials to modify some proposed laws and regulations.

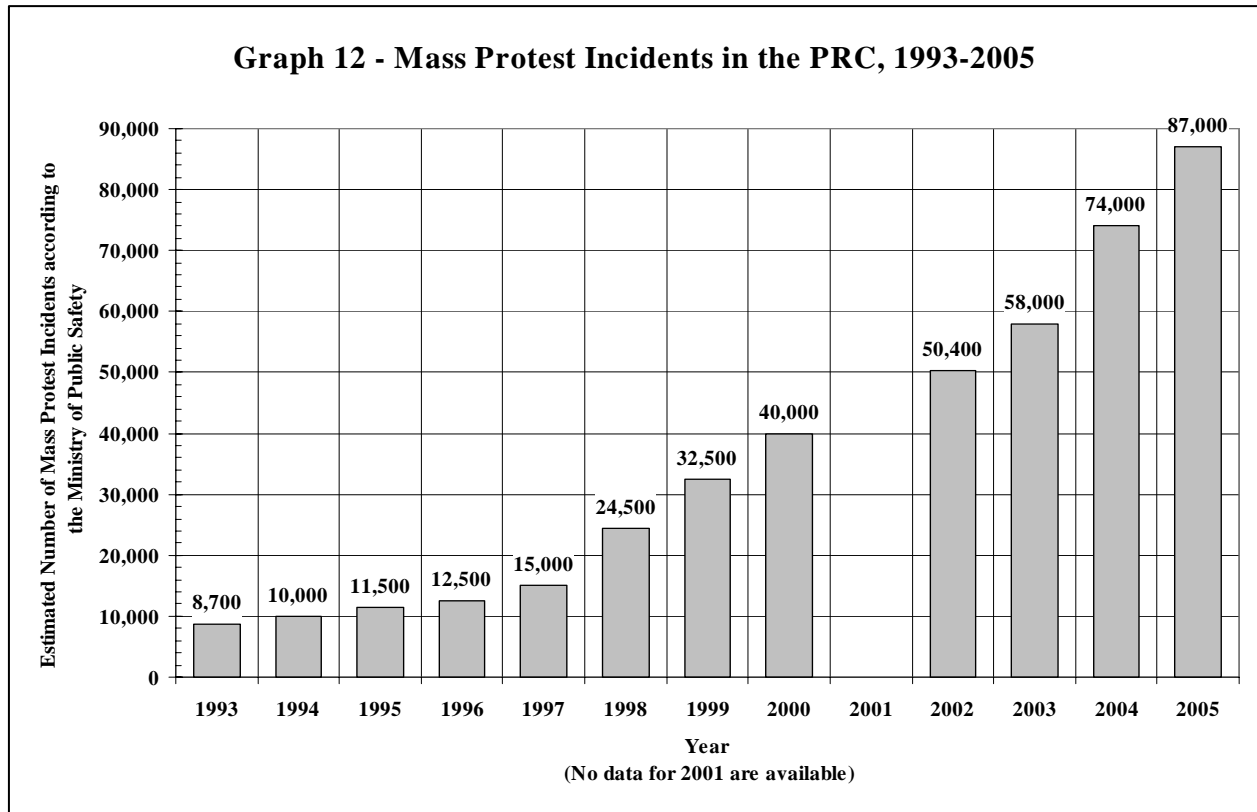
<sup>21</sup> *China in the Global Economy*, “Civil Service Reform in China” (Paris: Organization for Economic Cooperation and Development, 2005): 55-60.

<sup>22</sup> *Transparency International Corruptions Practices Index 2005*, found at <http://transparency.org>.

<sup>23</sup> The family name of this Chinese economist is listed last, according to western fashion.

<sup>24</sup> Julie Chao, “China is Losing Battle with Corruption,” *Milwaukee Journal Sentinel* (December 8, 2002).

<sup>25</sup> *China Economic Quarterly* (First Quarter 2005): 48.



Indigenous creative industries could create new high-skill, high-wage jobs to replace the low-skill, low-wage jobs in labor-intensive manufacturing and assembly operations that the PRC is likely to lose in future years. However, corruption stifles the development of indigenous creative industries that depend on secure intellectual property rights.

Corruption, particularly the uncompensated seizure of land for development, fuels growing unrest. The reported number of mass protests soared ten-fold over twelve years, reaching 87,000 protests in 2005 (see Graph 12).<sup>26</sup> The central government has responded to the growing number of mass protests by:

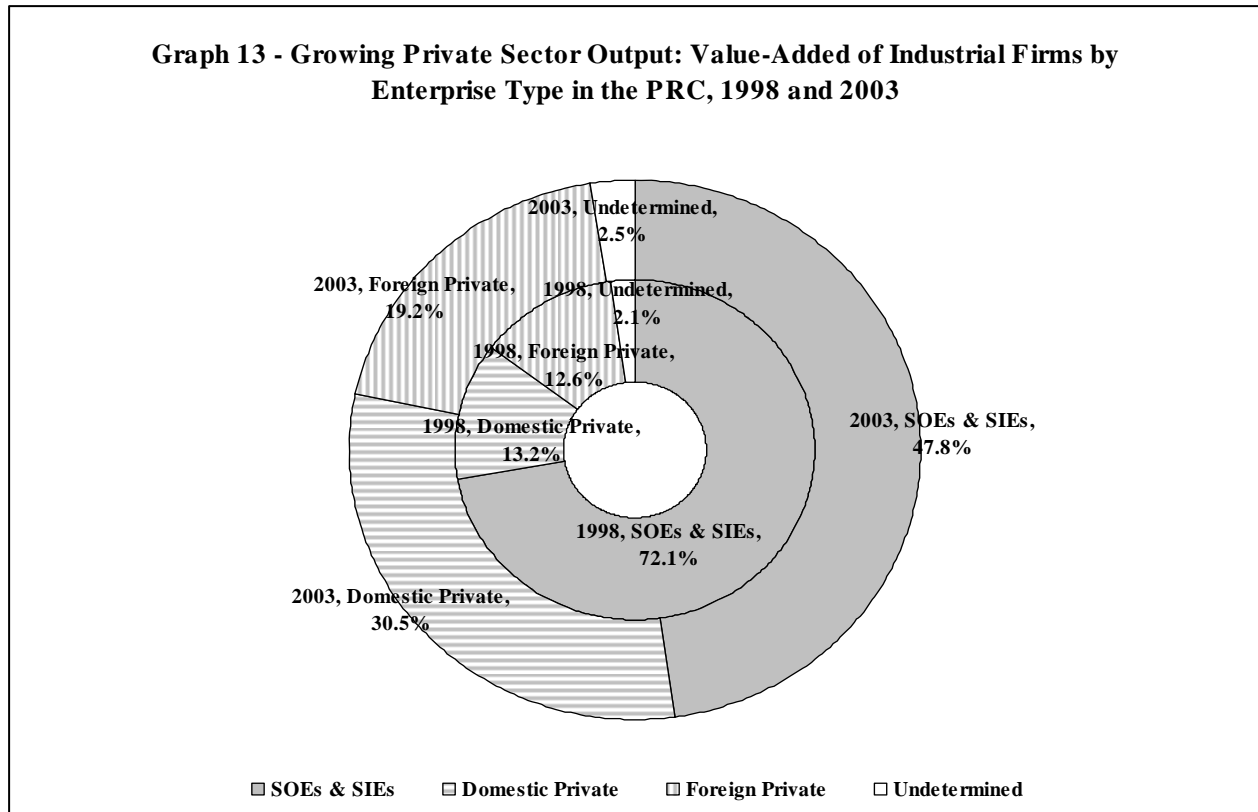
- acknowledging problems;
- appeasing ordinary protestors by making superficial changes (e.g., dismissing and prosecuting corrupt local officials); and
- punishing protest leaders to prevent local protests from coalescing into a national movement.

So far, the central government has been able to contain local protests. How successful this strategy will be in future is difficult to predict.

## **VI. FINANCIALLY DISTRESSED STATE-OWNED ENTERPRISES AND STATE-INFLUENCED ENTERPRISES**

Early economic reforms that introduced the price system and profit incentives to the SOEs did not significantly improve their performance. Consequently, President Jiang Zemin

<sup>26</sup> Found at: [http://www.chinabalancesheet.com/Documents/Data\\_Domestic\\_Sociopolitical.PDF](http://www.chinabalancesheet.com/Documents/Data_Domestic_Sociopolitical.PDF).



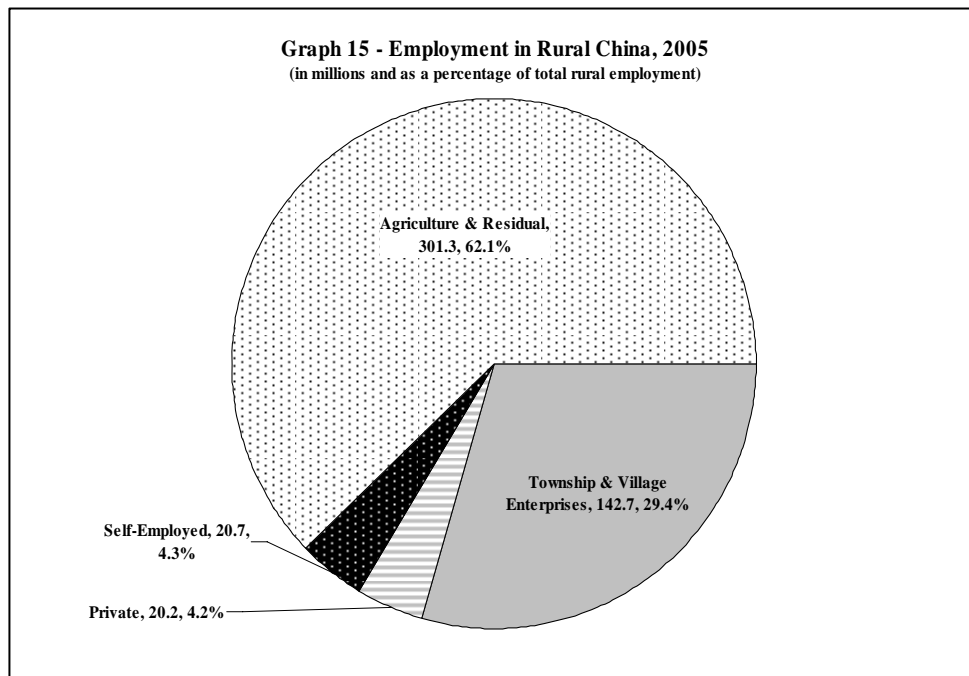
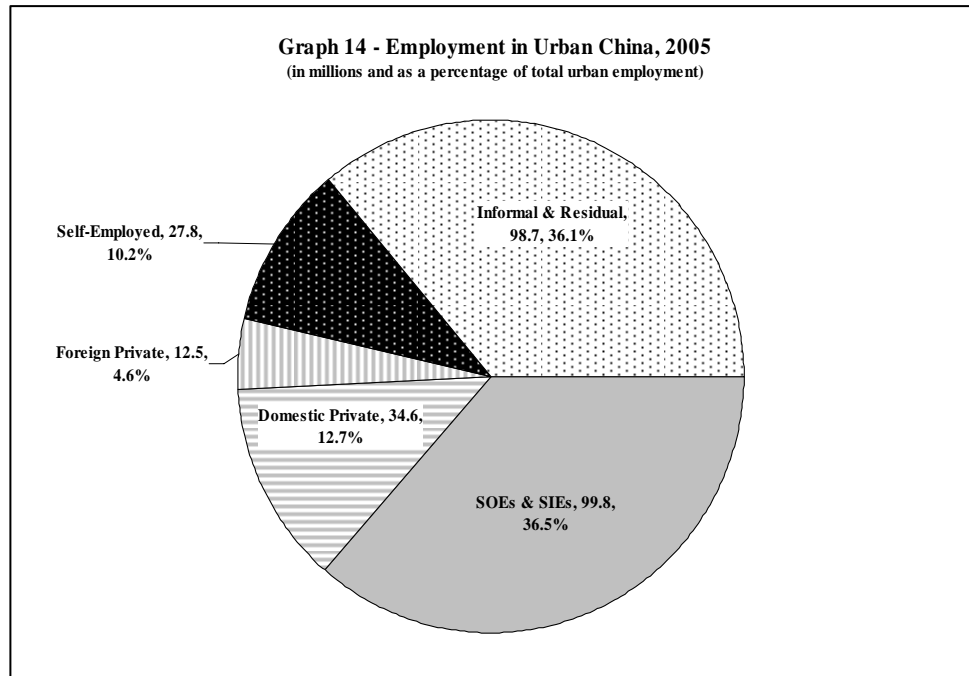
announced the *zhuada fangxiao* policy (i.e., grab the big, dump the small) at the Fifteenth Party Congress in 1997. Under this policy, the central government retained ownership of state-owned enterprises that:

- produce defense goods and services;
- are in industrial sectors targeted for economic development; or
- are hopelessly insolvent, but employ millions.

The central government has transformed many of the large state-owned enterprises that it had retained into shareholding enterprises by issuing minority shares to investors. While shareholding enterprises exhibit many of the characteristics of private corporations, the central government still exercises effective control over their operations. At year-end 2005, the central government still controlled 66 percent of the market value of all shareholding enterprises through non-marketable shares. In the *Australian Financial Review*, Stephen Wyatt concluded:

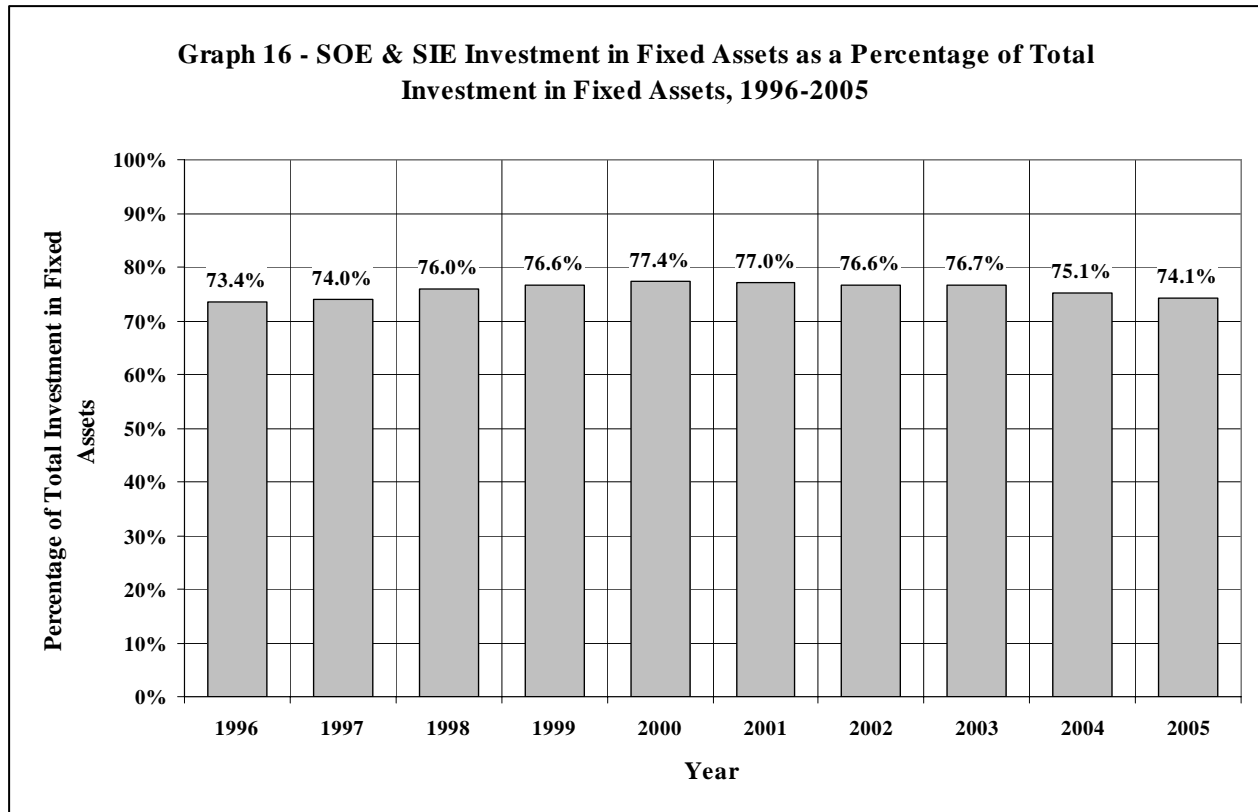
*In fact, the entire privatization of China's state-owned enterprises is still more hype than reality. ... The government's strategy is still to list minority shares in state-owned groups in order to raise capital and import better governance while ultimately retaining control ...*<sup>27</sup>

<sup>27</sup> Stephen Wyatt, "Privatization More Hype than Reality," *Australian Financial Review* (June 7, 2005).



The remaining small- and medium-sized state-owned enterprises were converted into a variety of state-influenced enterprises:

- Township and village enterprises (TVEs) in rural areas;
- Cooperative enterprises owned by their employees;
- Collective enterprises owned by provincial governments and local governments in urban areas;



- Private domestic enterprises often sold to officials or their families; and
- Joint enterprises owned by a state-owned enterprise in conjunction with another type of enterprises.

SOEs and SIEs remain a major part of the PRC's economy:

- Producing 47.8 percent of the value-added among industrial firms in the PRC during 2003 (see Graph 13);<sup>28</sup>
- Employing 99.8 million in urban areas during 2005 (see Graph 14);<sup>29</sup>
- Employing 142.7 million in rural areas during 2005 (see Graph 15);<sup>30</sup> and
- Accounting for 74.1 percent of the PRC's investment in fixed assets during 2005 (see Graph 16).<sup>31</sup> SOEs and SIEs are a significant source of patronage for the CPC. In 2003, SOEs and SIEs employed 5.3 million party members as executives or senior managers.<sup>32</sup>

<sup>28</sup> OECD Survey: 126.

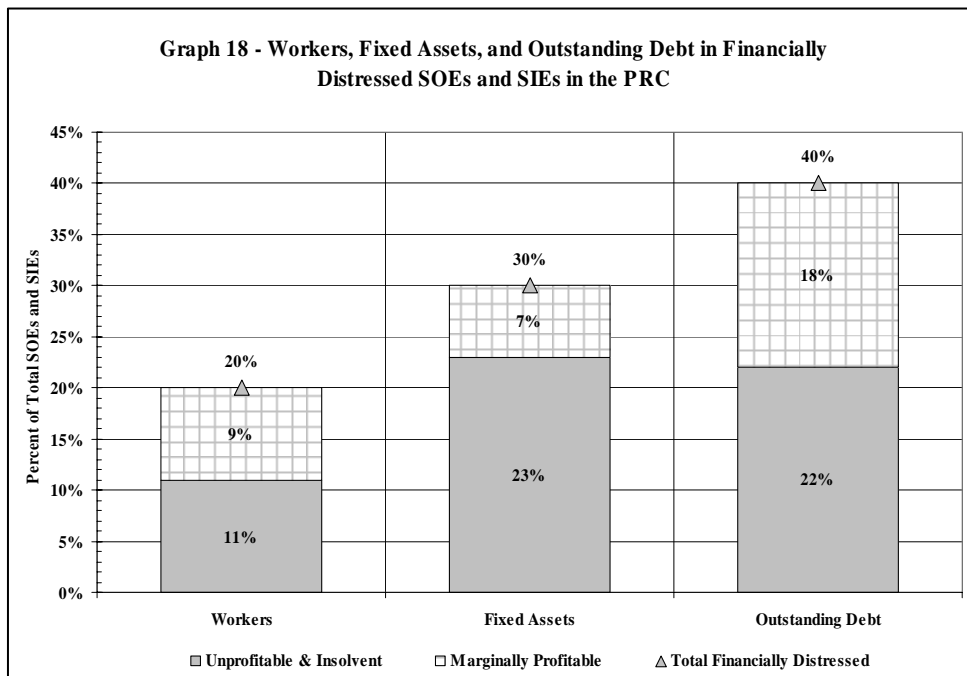
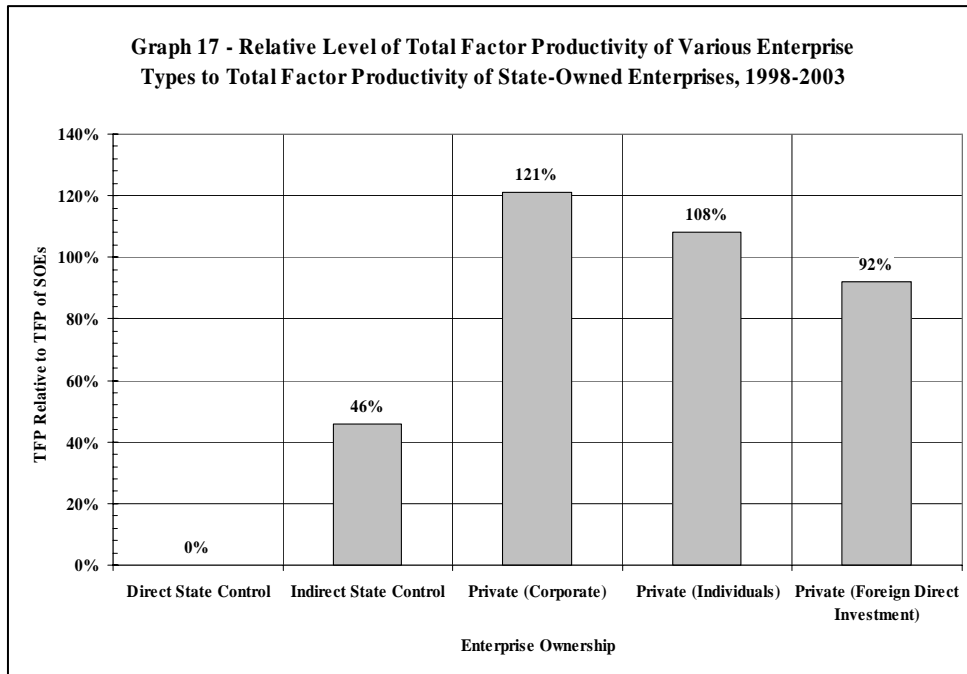
<sup>29</sup> China National Bureau of Statistics/Haver Analytics.

<sup>30</sup> Ibid.

<sup>31</sup> Author's calculation based on data from China National Bureau of Statistics/Haver Analytics.

<sup>32</sup> Minxi Pei, "Politics Blamed for China's Trillion-Dollar Bad Debts," *The Australian* (May 9, 2006). Found at <http://www.theaustralian.news.com/printpage/0,5942,19067992,00.html>.





However, SOEs and SIEs are notoriously inefficient. The Organization for Economic Cooperation and Development (OECD) measured the total factor productivity (TFP) in a broad cross-section of firms in the PRC. TFP refers to the portion of the increase in economic output that cannot be attributed to increases in the quantity or the quality of factor inputs. Thus, TFP represents the gains in output from efficiency and innovation. The OECD found that the TFP of private Chinese firms and Chinese subsidiaries of foreign multinational firms is double the TFP of SOEs and one and one-half times the TFP of SIEs

during 1998-2003 after controlling for size, location, and industry (see Graph 17).<sup>33</sup>

Consequently, the average return on equity was 6.7 percent in all SOEs during 2003.<sup>34</sup> Moreover, the OECD found insolvent or unprofitable SOEs and SIEs accounted for 11 percent of the workers, 23 percent of the fixed assets, and 22 percent of the outstanding debt in all SOEs and SIEs. Marginally profitable SOEs and SIEs accounted for 9 percent of the workers, 7

<sup>33</sup> OECD Survey: 86.  
<sup>34</sup> OECD Survey: 105.

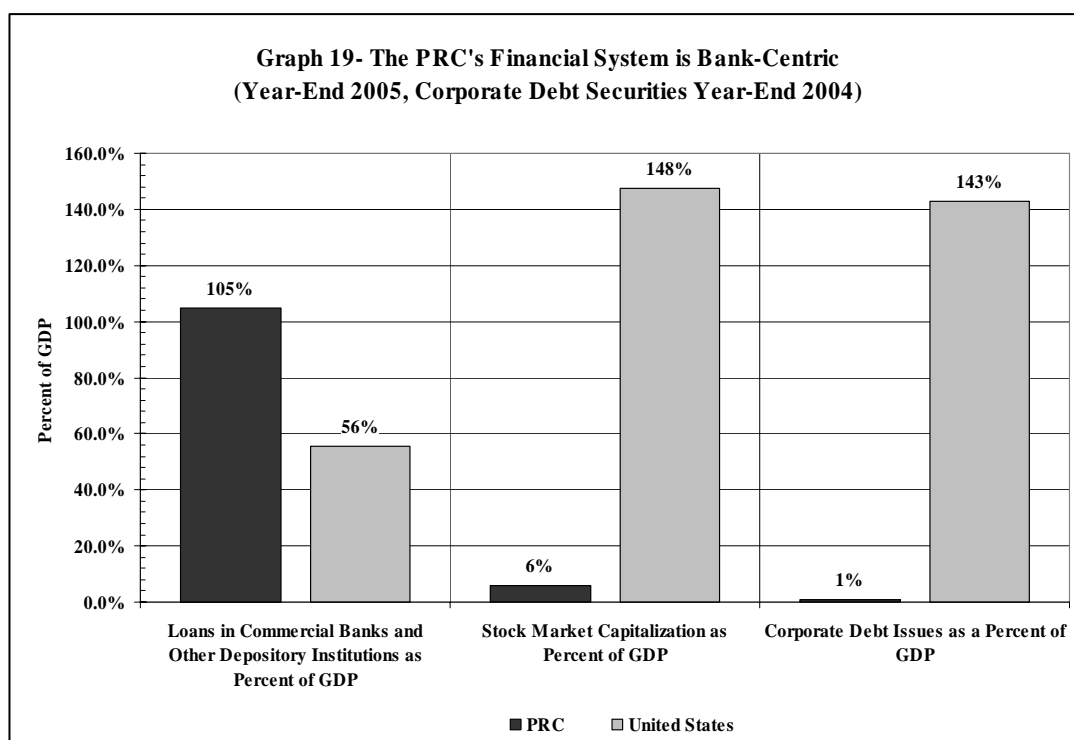
percent of the fixed assets, and 18 percent of the outstanding debt in all SOEs and SIEs. When combined, these financially distressed SOEs and SIEs accounted for 20 percent of the workers, 30 percent of the fixed assets, and 40 percent of the outstanding debt in all SOEs and SIEs (see Graph 18).<sup>35</sup>

SOEs and SIEs use their *guanxi* to secure favorable regulations and preferential access to loans from Chinese banks and other depository institutions. Consequently, many SOEs and SIEs face a “soft budget constraint” (i.e. Chinese banks and other depository institutions lend to the SOEs and SIEs without regard to their ability to repay their loans). Non-market loans allow many financially distressed SOEs and SIEs to continue operations and invest in new fixed assets when market discipline would force these SOEs and SIEs to shutter operations or to forego the acquisition of fixed assets.

## VII. A DYSFUNCTIONAL FINANCIAL SYSTEM

### A. *Bank-Centric, State-Directed Financial System*

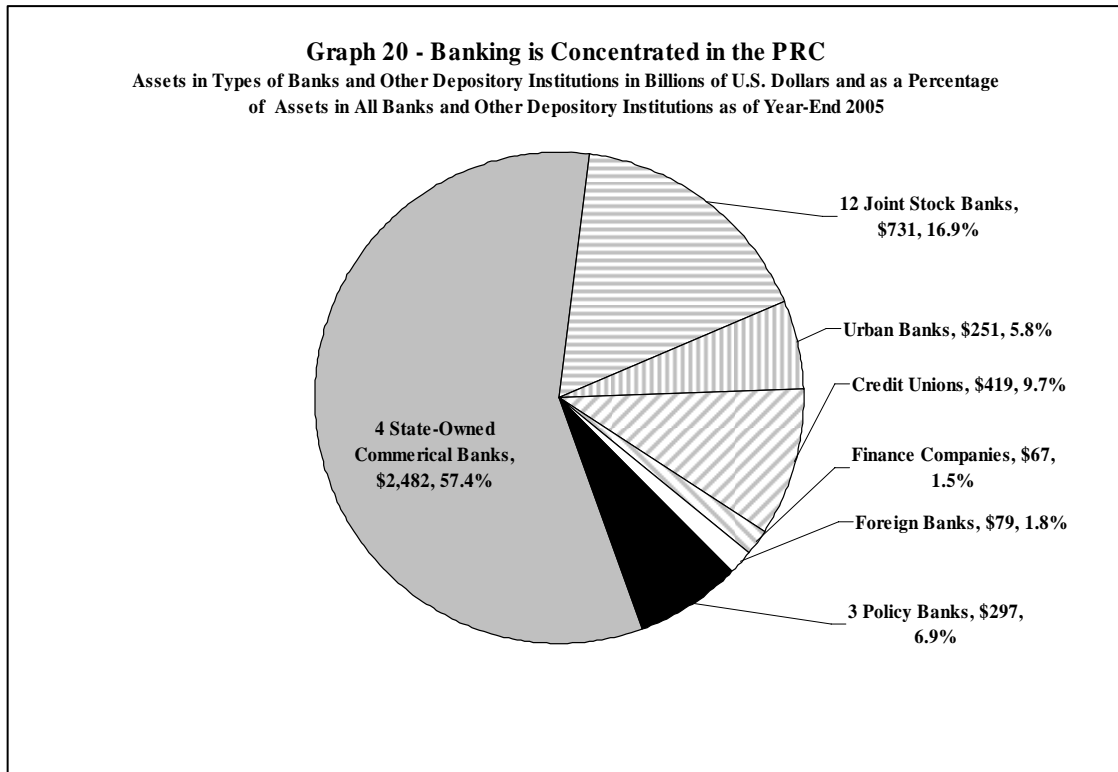
The PRC’s financial system is very bank-centric. At year-end 2004, corporate debt issues amounted to 1 percent of GDP in China compared to 143 percent of GDP in the United States.<sup>36</sup> At year-end 2005, equity issues (marketable shares) amounted to 6 percent of GDP in China compared to 148 percent of GDP in the United States,<sup>37</sup> and loans at banks and other depository institutions amounted to 105 percent of GDP in China compared to 56 percent of



<sup>35</sup> OECD Survey: 102-104.

<sup>36</sup> OECD Survey: 42; author’s calculation based on data from World Federation of Exchanges and U.S. Bureau of Economic Analysis/Haver Analytics.

<sup>37</sup> Author calculation based on data from China Securities Regulatory Commission/Haver Analytics, China National Bureau of Statistics/Haver Analytics, New York Stock Exchange and NASDAQ/Haver Analytics, and U.S. Bureau of Economic Analysis/Haver Analytics.



GDP in the United States (see Graph 19).<sup>38</sup>

Banking assets are highly concentrated in the PRC (see Graph 20). The four major state-owned commercial banks – the Agricultural Bank of China, the Bank of China, China Construction Bank, and the Industrial Commercial Bank of China – controlled 57.1 percent of banking assets at year-end 2005.<sup>39</sup> Twelve joint stock commercial banks<sup>40</sup> controlled another 16.8 percent of banking assets at year-end 2005.<sup>41</sup>

Despite some progress in developing credit evaluation and risk management skills, non-market criteria may still influence over one-half of lending decisions. This occurs through both

<sup>38</sup> Author's calculation based on data from the People's Bank of China/Haver Analytics, China National Bureau of Statistics/Haver Analytics, Federal Reserve Flow of Funds/Haver Analytics, and U.S. Bureau of Economic Analysis/Haver Analytics.

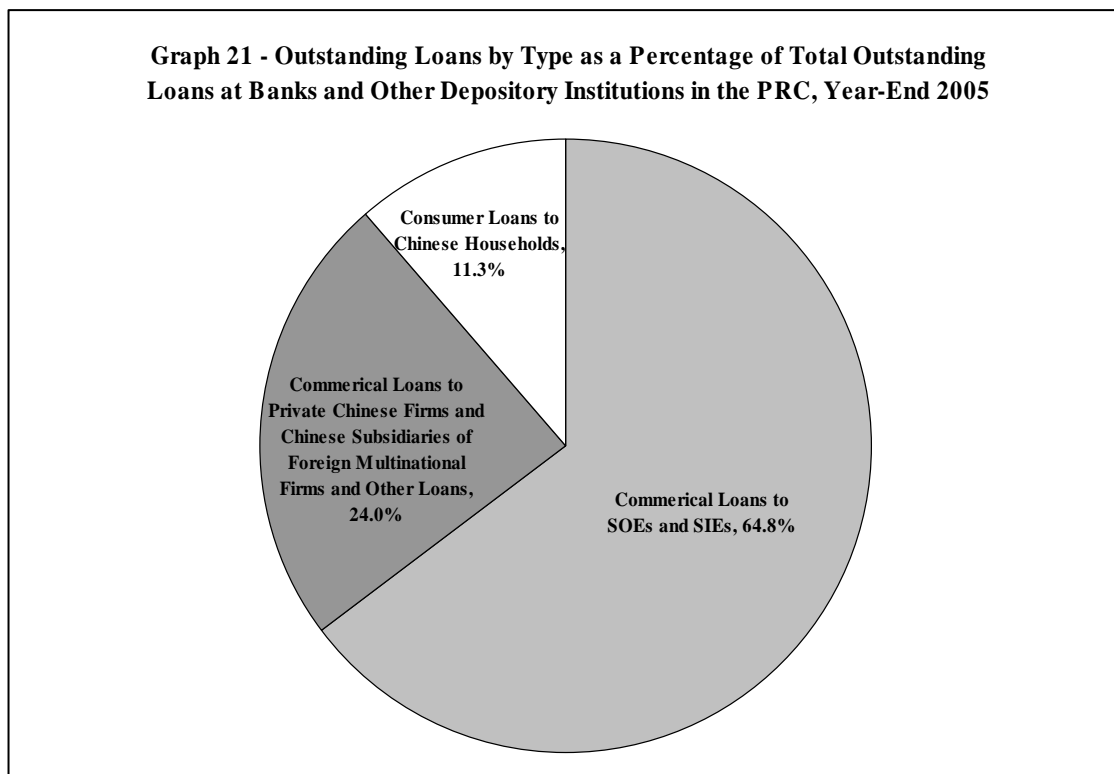
<sup>39</sup> Ibid.

<sup>40</sup> The twelve joint stock commercial banks are:

1. Bank of Communications
2. CITIC Bank
3. Everbright Bank
4. Evergrowing Bank
5. Hua Xia Bank
6. Guangdong Development Bank
7. Shenzhen Development Bank
8. China Merchants Bank
9. Shanghai and Pudong Development Bank
10. Industrial Bank
11. Minsheng Bank
12. Zheshang Bank

<sup>41</sup> Author's calculation based on data from People's Bank of China/Haver Analytics.

**Graph 21 - Outstanding Loans by Type as a Percentage of Total Outstanding Loans at Banks and Other Depository Institutions in the PRC, Year-End 2005**



*guanxi* loans<sup>42</sup> and policy loans.<sup>43</sup> Non-market lending affects the overall composition of the loan portfolios in Chinese banks and other depository institutions. While banks in other economies extend most of their loans to households and small- to medium-sized private firms, 64.5 percent of outstanding loans in the PRC at year-end 2005 were extended to SOEs and SIEs (see Graph 21).<sup>44</sup>

Centrally directed industrial policy still governs the issuance of debt and equity securities in the PRC. The State Council -- the equivalent of the President's cabinet in the United States -- must approve the issuance of all equity securities on Chinese stock exchanges. The National Development and Reform Commission, which is the PRC's industry policy agency and reports to the State Council, must approve the issuance of all corporate debt securities. Consequently, nearly all of the proceeds from corporate debt and equity issues in the PRC have gone to SOEs and SIEs.<sup>45</sup>

<sup>42</sup> *Guanxi* lending refers to loans that banks make to individuals, firms, organizations, or governments based on personal relationships between bank officers and borrowers. Under *guanxi* lending, banks grant borrowers larger loans, lower interest rates, or more favorable terms than banks would willingly grant to borrowers without a personal relationship.

<sup>43</sup> Policy lending refers to loans that banks make to individuals, firms, organizations, or governments based on government regulations or suasion rather than market criteria. Under policy lending, banks grant borrowers larger loans, lower interest rates, or more favorable terms than banks would willingly grant in the absence of government regulation or suasion.

<sup>44</sup> Author's calculation based on data from People's Bank of China/Haver Analytics. Allocation of commercial loans to SOEs and SIEs and to private firms based on Diana Farrell et al., *Putting China's Capital to Work: The Value of Financial System Reform* (McKinsey Global Institute, May 2006): 11.

<sup>45</sup> *Ibid*: 15.

### **B. Economic Costs of Non-Market Allocation of Financing**

In a recent study of the PRC's financial system, Farrell et al. (2006) found that the non-market allocation of financing harms the Chinese economy in two ways:

- Non-market allocation of financing reduced the potential size of the PRC's GDP by \$321 billion a year or about 14 percent of its current GDP,<sup>46</sup> and
- Non-market allocation of financing has slashed the average real return on savings in the PRC to a mere 0.5 percent over the last decade. This compares to an average real return on savings in the United States of 3.1 percent over the same period.<sup>47</sup>

### **C. Nonperforming Loans**

Chinese banks and other depository institutions had a large legacy of nonperforming loans from non-market lending to SOEs and SIEs prior to 1999. Approximately \$170 billion of nonperforming loans have been transferred from the four major state-owned commercial banks to four asset management companies during 1999 and 2000.<sup>48</sup> So far, the asset management companies have disposed of 67 percent of these nonperforming loans, recovering about 21¢ on \$1 of face value. Another \$136 billion of nonperforming loans have been transferred to asset management companies during the last two years.

Both Chinese officials and private economists acknowledge that the PRC has done a good job in identifying and resolving pre-1999 nonperforming loans in Chinese banks and other depository institutions. However, Chinese officials and private economists disagree about the current size of the nonperforming loan problem in the PRC. In particular, Chinese officials and private economists have differences of opinion on how many loans made by Chinese banks and other depository institutions since 1998 are now or will become nonperforming loans.

The China Banking Regulatory Commission reported that nonperforming loans in commercial banks have fallen to \$164 billion, or 6.6 percent of GDP as of March 31, 2006.<sup>49</sup> Nonperforming loans in other depository institutions amounted to \$42 billion, or 1.7 percent of GDP as of March 31, 2006.<sup>50</sup>

In a widely publicized study, Ernst & Young estimated that nonperforming loans amounted to \$911 billion, or 41 percent of GDP at year-end 2005.<sup>51</sup> The People's Bank of China and the China Banking Regulatory Commission vigorously disputed the Ernst & Young

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<sup>46</sup> Ibid: 81.

<sup>47</sup> Ibid: 90-91.

<sup>48</sup> The PRC's central government established asset management companies to liquidate nonperforming loans. The PRC modeled their asset management companies on the Resolution Trust Corporation. Congress established the Resolution Trust Corporation in 1989 through the *Financial Institutions Reform, Recovery, and Enforcement Act*. The Resolution Trust Corporation liquidated the nonperforming loans and other assets of saving and loan associations that had been declared insolvent.

<sup>49</sup> Author's calculations based on data from China Banking Regulatory Commission/China National Bureau of Statistics/Haver Analytics.

<sup>50</sup> Charlene Chu, Lynda Lin, Kate Lin, and David Marshall, "China: Taking Stock of Banking System Nonperforming Loans," *Fitch Ratings* (May 30, 2006). Found at <http://www.fitchratings.com/dtp/pdf2-06/bchi3005.pdf>.

<sup>51</sup> *Global Nonperforming Loan Report*, Ernst & Young (May 3, 2006): 14. Author's calculation of nonperforming loans as a percent of GDP.

estimate. Under pressure from Chinese officials, Ernst & Young, which audits the Bank of China and the Industrial Commercial Bank of China, withdrew its study nine days after its release.<sup>52</sup>

However, the withdrawn Ernst & Young estimate is broadly in line with other private estimates. As of March 31, 2006, for example, Fitch Ratings estimated that commercial banks and other depository institutions had another \$270 billion of problem loans in addition to \$164 billion of officially reported nonperforming loans in commercial banks, \$42 billion of officially reported nonperforming loans in other depository institutions, and \$197 billion of nonperforming loans remaining in the asset management companies.<sup>53</sup> If all of the estimated problem loans become nonperforming, then nonperforming loans would equal \$673 billion, or 27.3 percent of GDP as of March 31, 2006.

Because of insecure property rights, capricious zoning, arbitrary inspections, and widespread corruption, individuals and private firms without strong *guanxi* with the government and party officials cannot easily participate in the real estate industry. Thus, most construction firms and developers in the PRC are SOEs or SIEs. Real estate speculation is now rampant in major Chinese cities. On June 13, 2006, *Business Week* recently reported:

*People's Bank of China deputy governor Wu Xiaoling has warned publicly that the value of total private and commercial investment in real estate shot up from about 2.5 percent of total gross domestic product in 2001 to 8.6 percent in 2005. "Real estate bubbles will affect the economy and people's lives seriously, especially when bubbles burst,"*<sup>54</sup>

In the last few years, Chinese banks and other depository institutions have aggressively lent to SOEs and SIEs for construction and real estate development. This explosive loan growth may be creating mountains of new nonperforming loans in Chinese banks and other depository institutions that bank and government officials have not yet recognized.

#### **D. Recapitalization**

To recapitalize ailing banks, the PRC's central bank, the People's Bank of China, injected \$60 billion of foreign exchange reserves into the four major state-owned commercial banks between 2003 and 2005. During 2005, foreign financial services firms invested \$18 billion in minority shares in Chinese banks (see Table 1).

An initial public offering (IPO) of 13 percent of the shares raised \$9.2 billion for the China Construction Bank in October 2005, while an IPO of 10.5 percent of the shares raised \$9.7 billion for the Bank of China in May 2006. During the rest of 2006, IPOs are expected to raise

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<sup>52</sup> Elaine Kurtenbach, "Ernst & Young Nixes Report Putting China's Potential Nonperforming Loans at US\$911 Billion," *Financial Times* (May 15, 2006). Found at [http://search.ft.com/searchArticle?id=060515009128&query=Ernst+%26+Young+China&vsc\\_appId=powerSearch&offset=0&resultsToShow=10&vsc\\_subjectConcept=&vsc\\_companyConcept=&state=More&vsc\\_publicationGroup=TOPWFT&searchCat=-1](http://search.ft.com/searchArticle?id=060515009128&query=Ernst+%26+Young+China&vsc_appId=powerSearch&offset=0&resultsToShow=10&vsc_subjectConcept=&vsc_companyConcept=&state=More&vsc_publicationGroup=TOPWFT&searchCat=-1).

<sup>53</sup> Charlene Chu, Lynda Lin, Kate Lin, and David Marshall, "China: Taking Stock of Banking System Nonperforming Loans," *Fitch Ratings* (May 30, 2006). Found at <http://www.fitchratings.com/dtp/pdf2-06/bchi3005.pdf>.

<sup>54</sup> Brian Bremner, "China: Big Economy, Bigger Peril?" *Business Week* (June 13, 2006). Found at: [http://www.businessweek.com/globalbiz/content/jun2006/gb20060613\\_168050.htm](http://www.businessweek.com/globalbiz/content/jun2006/gb20060613_168050.htm).

about \$10 billion for the Industrial Commercial Bank of China, \$2 billion for the China Merchants Bank, \$1 billion for the Minsheng Bank, and \$1 billion for the CITIC Bank.

<b>Table 1 – Foreign Direct Investment in Chinese Banks</b>		
<i>Chinese Banks</i>	<i>Foreign Investors</i>	<i>Ownership</i>
Industrial Commercial Bank of China	Goldman Sachs, American Express, & Allianz Group	10%
China Construction Bank	Bank of America	8.67% (may increase to 19.9%)
	Temasek Holdings	5.98%
Bank of China	Royal Bank of Scotland	10%
	Merrill Lynch, Li Ka-Shing, & Temasek Holdings	10%
	UBS	1.6%
	Asian Development Bank	0.24%
Bank of Communications	HSBC	19.9%
Shanghai Pudong Development Bank	Citigroup	4.6% (may increase to 24.9%)
Minsheng Bank	IFC	0.93%
	Temasek Holdings	3.9%
Industrial Bank	Hang Seng Bank	15.98%
	IFC	4%
	Singapore Investment	5%
Hu Xia Bank	Deutsche Bank	9.9%
	Sal Oppenheim	4.08%
	Pangaea Capital Management	6.9%
Shenzhen Development Bank	Newbridge Capital	17.98% (will drop)
	GE Capital	7.3% (pending)
Guangdong Development Bank	Citigroup	Seeking 85%
Beijing Bank	ING Group	19.9%
	IFC	5%
Shanghai Bank	HSBC	8%
	IFC	7%
Nanjing City Commercial Bank	IFC	5%
	BNP	19.2%
Tiajin Bohai Bank	Standard Chartered	19.99%
Hangzhou City Commercial Bank	Commonwealth Bank of Australia	19.99%
Jinan City Commercial Bank	Commonwealth Bank of Australia	11%
Xian City Commercial Bank	IFC	2.5%
	Bank of Nova Scotia	2.5%
Ping An Bank	HSBC	27%
Nanchong City Commercial Bank	DEG	10%
	SIDT	3.3%
Ningbo City Commercial Bank	Oversea-Chinese Banking Corp.	12.2%

In March 2006, the *Economist Intelligence Unit* observed:

*[Q]uestions remain over whether risk management standards in the banking sector have improved in a way that would prevent such problems*

*from re-emerging. One particular problem is the government's strong control over lending patterns, which encourages capital to be allocated on the basis of policy rather than profit.<sup>55</sup>*

Senior PRC officials face a conundrum. If the government were to cede its control over Chinese banks, they would curtail their non-market lending and strengthen their balance sheets. Market lending would use Chinese saving more efficiently. Consequently, the PRC's long-term real GDP growth would be higher, and Chinese households would earn a better return on their savings. However, curtailing non-market lending would cause many financially distressed SOEs and SIEs to fail, leading to higher unemployment in the short run. These short-term dislocations could break the "bargain" that has kept the CPC in power.

Non-market lending may buy political stability for a time. However, in its accession agreement with the World Trade Organization, the PRC committed to open its domestic banking market to foreign banks in 2007, allowing them make loans to and receive deposits from all Chinese households and firms in yuan. Implementing this commitment will create a viable alternative to Chinese banks and other depository institutions for Chinese households and firms.

Unlike the United States, the central government does not insure deposits in Chinese banks and other depository institutions. If financial weaknesses are allowed to fester, runs, in which a large number of depositors suddenly attempt to withdraw all of their funds from Chinese banks and place them in "safer" foreign banks, could soon occur. Runs could cause some Chinese banks to fail. To avert a financial panic and a possible recession, the People's Bank of China and the central government would likely be forced to bail out failing banks.

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<sup>55</sup> *Economist Intelligence Unit* (2006): 30.





## VIII. DOMESTIC AND INTERNATIONAL IMBALANCES

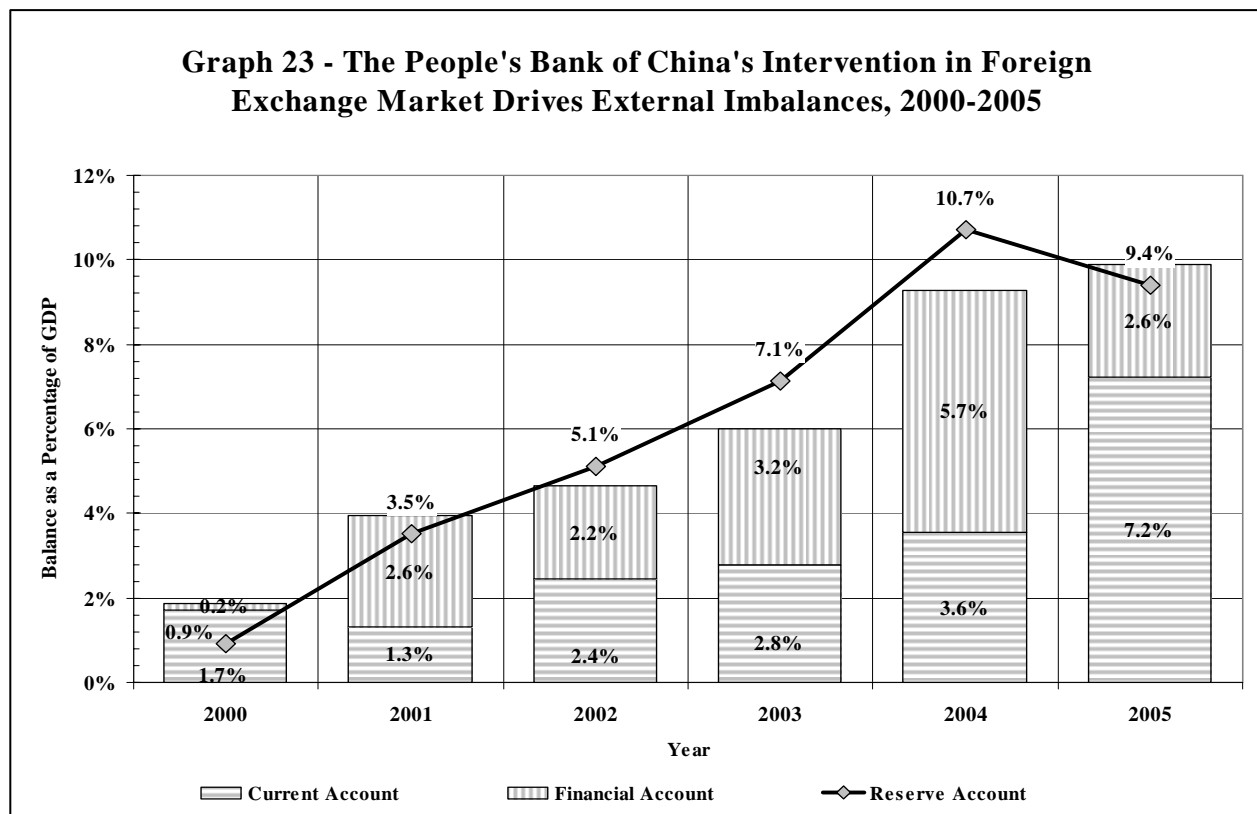
On July 21, 2005, the PRC broke its previous peg with the U.S. dollar, revalued the renminbi<sup>56</sup> by 2.1 percent, and instituted an adjustable exchange rate tied to a basket of currencies including the U.S. dollar. Prior to this change, the People's Bank of China actively intervened in foreign exchange markets to maintain the peg of the renminbi to U.S. dollar. Nevertheless, the People's Bank of China continued to actively intervene to limit any appreciation of the renminbi against the U.S. dollar. One year after this change, the renminbi has appreciated by only 3.56 percent against the U.S. dollar (from 1 yuan equal to 12.0824 U.S. cents on July 21, 2005, to 1 yuan equal to 12.5128 U.S. cents on July 20, 2006).<sup>57</sup>

Graph 22 shows the accumulation of foreign exchange reserves in terms of both U.S. dollars and as a percentage of the PRC's GDP. By year-end 2005, the People's Bank of China accumulated \$819 billion, or 36.8 percent of GDP, in foreign exchange reserves. Through June 2006, the People's Bank of China accumulated foreign exchange reserves of \$941 billion, an increase of 14.9 percent in just six months.<sup>58</sup>

<sup>56</sup> In the United States, "dollar" is both the name of the U.S. currency and of its unit of account. In the People's Republic of China, the "renminbi" is the name of the PRC's currency, and "yuan" is the name of the PRC's unit of account.

<sup>57</sup> Equivalently, the U.S. dollar has depreciated by only 3.44 percent against the renminbi (from \$1 equal to 8.2765 yuan on July 21, 2005, to \$1 equal to 7.9918 yuan on July 20, 2006). Federal Reserve Bank of New York/Haver Analytics.

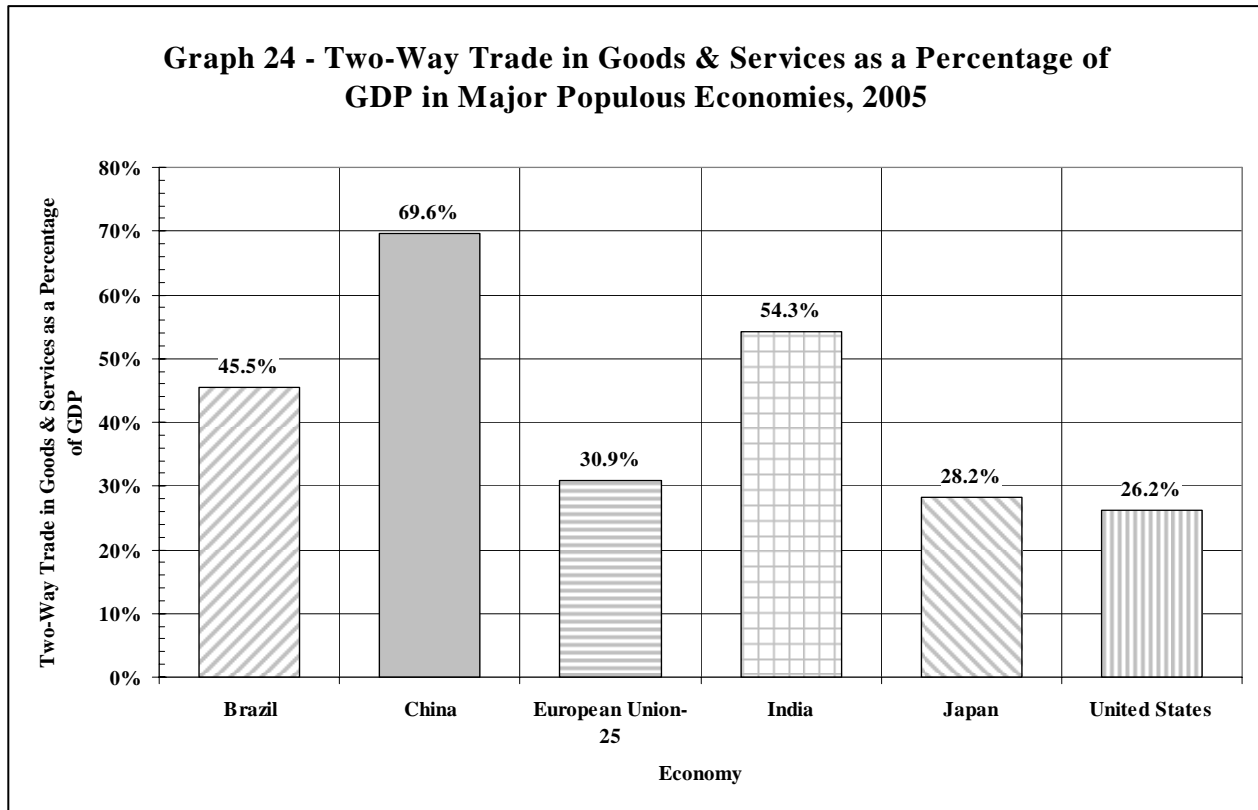
<sup>58</sup> People's Bank of China, State Administration of Foreign Exchange, and China National Bureau of Statistics /Haver Analytics.



Interventions of the People’s Bank of China suppress the foreign exchange value of the renminbi below a market-determined level. In November 2005, Morris Goldstein at the Institute for International Economics estimated that the renminbi was undervalued by between 20 percent and 40 percent using an underlying balance approach and by between 20 percent and 30 percent using a global payments balance approach. This is broadly in line with the majority of private sector estimates.<sup>59</sup> This exchange rate policy contributes to both domestic and international balances.

Graph 23 shows how the interventions of the People’s Bank of China drive the PRC’s external imbalances. In the absence of official intervention, the sign on the current account balance and the financial account balance should be opposite. However, during the last six years, the PRC has run both current account surpluses (in horizontal stripe) and financial account surpluses (in vertical stripe). Official intervention through the reserve account (as represented by the solid black line with diamonds) has made current account and financial account surpluses possible simultaneously.

<sup>59</sup> Morris Goldstein, *Renminbi Controversies*, Prepared for the Conference on Monetary Institutions and Economic Development, Cato Institute, November 3, 2005, revised December 2005): 1-4.



**A. *Underconsumption and Dependency on Export-Led Growth***

Chinese farmers are notoriously inefficient. The average productivity of a Chinese farmer is one-sixteenth of the average productivity of other Chinese workers. This widening productivity gap is increase income inequality between urban and rural areas in the PRC. The OECD reported that the average income of urban workers was three times the average income of rural workers.<sup>60</sup>

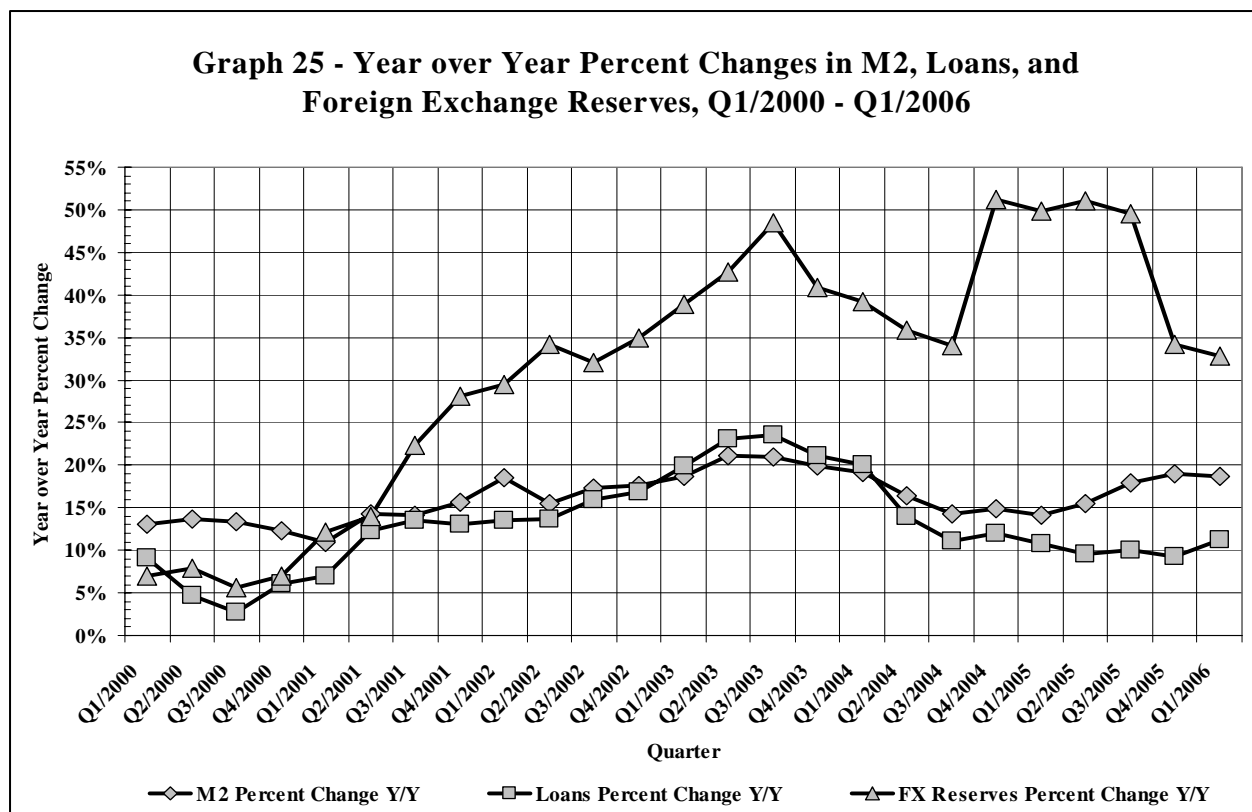
Chinese farmers may lease agricultural land from local governments for up to 30 years.<sup>61</sup> Unlike residential, commercial, or industrial lessees, however, agricultural lessees may not mortgage or transfer their leases. Moreover, a survey found that only 13 percent of agricultural leases forbid local officials from reallocating land during the term of a lease.<sup>62</sup> If agricultural lessees were to stop farming and move to a city, they would forfeit their leases, and their land would be redistributed to other farmers.<sup>63</sup> Consequently, Chinese farmers have neither the ability nor the incentive to invest in fixed assets that would improve their productivity and increase their income.

<sup>60</sup> OECD Survey: 44-45.

<sup>61</sup> The implementation of 30-year leasing is not universal and varies widely both among and within provinces. A survey found that only one-third of the villages in eleven provinces had implemented 30-year leasing. In the remaining villages, half of the agricultural land was leased on a long-term basis, while the remainder was leased through annual actions. OECD Survey: 113.

<sup>62</sup> OECD Survey: 113.

<sup>63</sup> In some cases, farmers may change their residential registration to a nearby village without losing their leases. However, these lessees may be required to pay additional fees to their local government to retain their leases. OECD Survey: 113.



Under its accession agreement with the World Trade Organization, the PRC agreed to open its domestic market to agricultural imports. If the renminbi were to appreciate rapidly and substantially, many Chinese farmers would not be able to compete with cheaper agricultural imports and would cease farming.

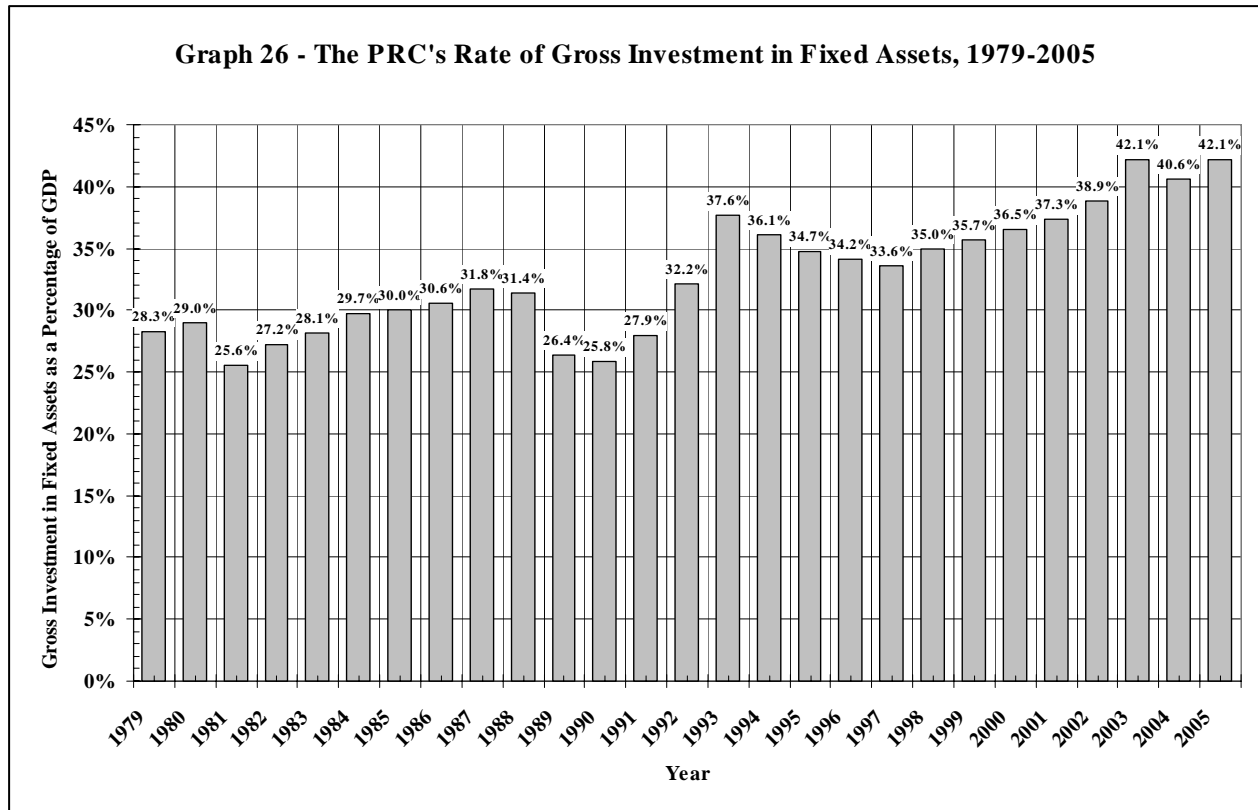
Because millions of Chinese are still employed in agriculture, currency appreciation could trigger mass unemployment and political instability in rural areas. On May 16, 2006, *Business Week* reported:

*“To the Chinese government, the agricultural industry and small farm villages are the biggest political issue,” says former Japanese financial diplomat Eisuke Sakakibara.<sup>64</sup>*

Under the “harmonious society” policy, President Hu Jintao is trying to increase rural income and provide alternative employment for displaced farmers by abolishing the two-thousand-year-old agricultural tax, expanding micro-financing for starting small businesses, and investing in mega-projects in rural areas. Consequently, Hu wants the renminbi to appreciate very slowly until the benefits of these measures become apparent.

However, this exchange rate policy creates profound imbalances in the rest of the PRC’s economy. Intervention reduces the real incomes of Chinese workers and their consumption of imported goods and services. Consequently, the PRC cannot rely on domestic consumption to drive its economic expansion. The PRC remains overly dependent on exports and investment for

<sup>64</sup> Brian Bremner, “Controlling China’s Runaway Growth,” *Business Week* (May 16, 2006). Found at: [http://www.businessweek.com/globalbiz/content/may2006/gb20060516\\_457180.htm](http://www.businessweek.com/globalbiz/content/may2006/gb20060516_457180.htm).



economic growth. Consequently, the PRC's two-way trade as a percent of its GDP is far higher than other populous economies (see Graph 24).

### **B. Overinvestment and Malinvestment**

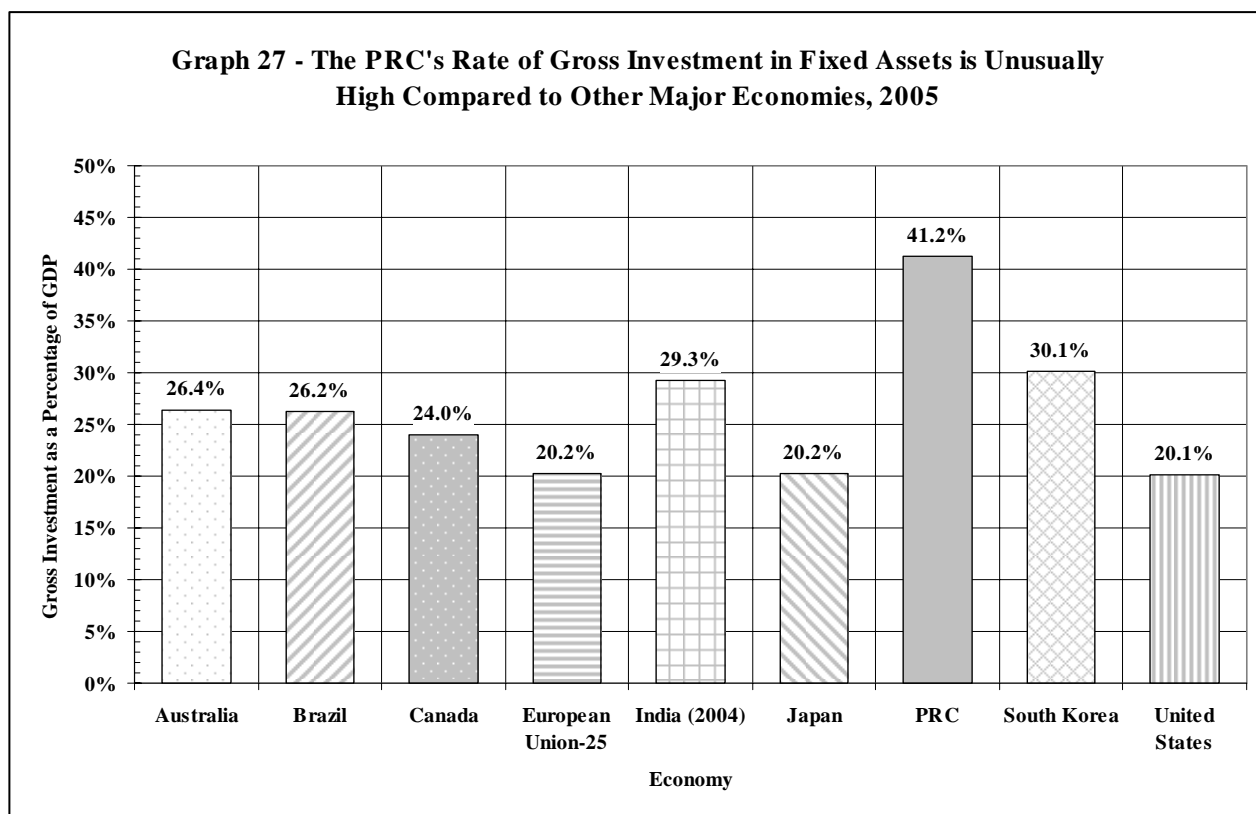
While the People's Bank of China has tried to sterilize its interventions, the International Monetary Fund reported that China was only able to mop-up about half of the excess liquidity through bond sales. The remainder of this excess liquidity has contributed to rapid growth in both M2 and loans since 2000. The International Monetary Fund noted that the loan growth would have been even higher without the administrative interventions of the People's Bank of China and the China Banking Regulatory Commission (see Graph 25).

The combination of (1) excessive liquidity from interventions that has not been fully sterilized and (2) *guanxi* loans and policy loans extended by Chinese banks has channeled funds to SOEs and SIEs, which invest in fixed assets. This aggressive lending helped to boost the PRC's rate of gross investment in fixed assets to 42.1 percent of GDP in 2005 (see Graph 26).<sup>65</sup> The PRC's gross investment rate is far higher than other major economies (see Graph 27).

Although the PRC's non-market allocation of financing may boost production and investment in the short term, the PRC's economic growth is sustainable over the long term if, and only if, firms:

- produce goods and services that the market demands; and

<sup>65</sup> Author's calculations based on data from China National Bureau of Statistics/Haver Analytics.



- invest in fixed assets that have a positive net present value.<sup>66</sup>

The rapid accumulation of fixed assets by the SOEs and the SIEs suggests that overinvestment (i.e., the acquisition of too many fixed assets for producing goods and services given expected future demand) and malinvestment (i.e., the acquisition of the wrong types of fixed assets for producing goods and services to meet expected future demand) may be occurring in the PRC. According to the *Economist Intelligence Unit*, “Oversupply has driven down prices in many industries, such as vehicles, steel, and aluminum.”<sup>67</sup> Moreover, the *Economist Intelligence Unit* reported:

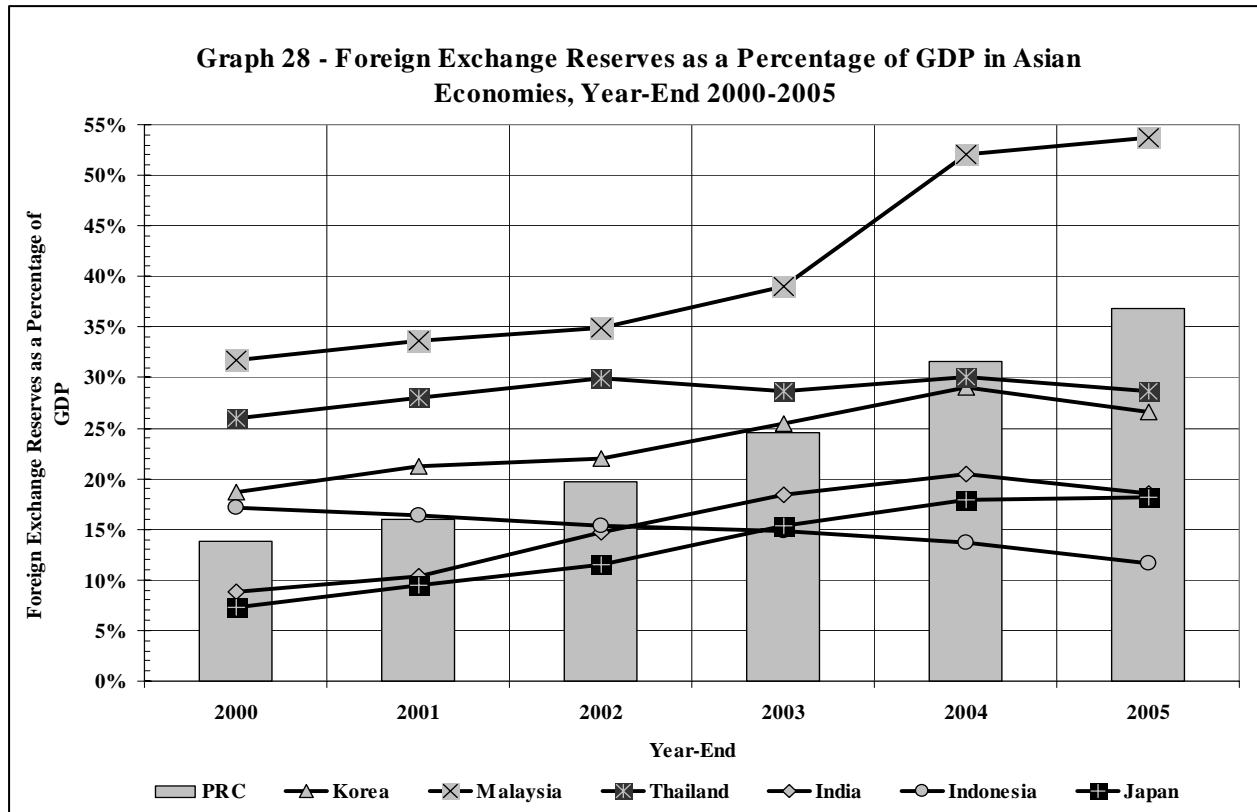
*Government officials have long warned of oversupply in the [steel] sector, and in December 2005 the head of the National Development and Reform Commission, Ma Kai, declared that oversupply had led steel prices to decline to 2003 levels, with the prices of some steel products falling below cost. (This was a serious admission for a Chinese official, as it could pave the way for anti-dumping suits in China’s steel export markets.)*<sup>68</sup>

An economic boom caused by overinvestment and malinvestment is not sustainable. The inevitable liquidation of overinvestment and malinvestment could cause a recession in the PRC and slow economic growth in the rest of the world.

<sup>66</sup> Net present value is the expected future revenues from an investment discounted by a rate that reflects the real interest rate, expected future inflation, and the risk associated with such investment less the current and future costs (also discounted) associated with the same investment.

<sup>67</sup> *Economist Intelligence Unit* (2006): 25.

<sup>68</sup> *Economist Intelligence Unit* (March 2006): 25-26.



To keep the renminbi undervalued, the People's Bank of China exchanges yuan for the U.S. dollars that the PRC's current and financial account surpluses pump into the Chinese economy. This intervention leaves Chinese banks and other depository institutions flush with cash. To remain profitable, Chinese banks are lending their excess deposits.

Senior PRC officials are clearly concerned that the excessive lending is fueling an overinvestment and malinvestment bubble. Fearing that higher interest rates would attract more foreign capital, the People's Bank of China is reluctant to increase interest rates significantly to curb the rapid growth of domestic bank loans and the resulting inflation of an investment bubble. Instead, senior officials are relying on moral suasion and regulatory changes to moderate loan growth. On June 16, 2006, the *Financial Times* reported that the State Council had issued a series of edicts intended to curb the rapid growth of bank lending and new investments in real estate development. The article observed:

*The root cause of the liquidity bubble, say economists, is China's managed currency, which has only appreciated by about 3 percent against the dollar since last July's decision to end a decade-long peg to the greenback.<sup>69</sup>*

Without a significant appreciation in the renminbi, private economists doubt that such administrative measures will have a significant effect.

<sup>69</sup> Richard McGregor, "Beijing Reins in Lending in Bid to Cool Growth," *Financial Times* (June 16, 2006).

### **C. *International Imbalances***

Because other developing Asian economies have labor-intensive industries and assembly operations that compete with the PRC, central banks in these economies fear that currency appreciation would put local firms or local subsidiaries of foreign multinational firms at a competitive disadvantage against Chinese firms or Chinese subsidiaries of foreign multinational firms. Thus, other developing Asian economies have mimicked the PRC's exchange rate policy (see Graph 28).

The People's Bank of China and central banks in other developing Asian economies use their accumulated foreign exchange to buy foreign debt securities, mainly U.S. Treasuries and Agencies, creating a non-market financial inflow into the United States. Given the accounting relationship between the current account and the capital and financial accounts, this non-market financial inflow increases the foreign exchange value of the U.S. dollar, the U.S. current account deficit, and the U.S. financial account surplus above market-determined levels. According to some economists, if the PRC and other developing Asian economies were to float their currencies, the U.S. current account deficit could decline by up to 10 percent.<sup>70</sup>

## **IX. ANALYSIS**

The PRC's current policies may not support a long-term continuation of the rapid growth that the Chinese economy has enjoyed in recent years. Because of the growing size of the Chinese economy and its deep integration through investment and trade flows with the rest of the world, a recession in the PRC would have adverse effects on the global economy.

The CPC's desire to retain power drove economic reform and shaped its contours. Senior officials are well aware that the PRC confronts a number of interrelated challenges to continued economic growth:

- A smaller working-age population will reduce China's labor supply. The combination of a higher labor demand and a smaller labor supply will inevitably increase the real compensation for all Chinese workers. Consequently, the PRC's current comparative advantage of low-cost labor will erode. The PRC will begin to shed many of the low-wage jobs in labor-intensive manufacturing and assembly operations that it has gained. To sustain economic growth and create high-wage replacement jobs, the PRC must climb the development ladder.
- The PRC currently faces a shortage of professionals and highly skilled workers. To alleviate this shortage, the PRC has increased the number of colleges and universities by 61.0 percent from 1,075 in 1990 to 1,731 in 2004 and quadrupled the number of students in post-secondary education.<sup>71</sup> However, this rapid expansion in the number of students appears to have undermined the quality of the post-secondary education that many students are receiving. Only about 10 percent of Chinese graduates receiving engineering degrees, for example, possess the minimum skills necessary for employment with U.S. engineering firms.<sup>72</sup> As the PRC begins to climb the development ladder, the demand for professionals

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<sup>70</sup> C. Fred Bergsten, "Clash of the Titans," *Newsweek* (international edition), April 24, 2006.

<sup>71</sup> *Economist Intelligence Unit* (March 2005): 20.

<sup>72</sup> Guy de Jonquieres, "The Critical Skills Gap," *Financial Times* (June 12, 2006).



and highly skilled workers will increase dramatically. The quality problems with the Chinese workforce may decelerate the PRC's economic growth rate.

- Corruption and the weak protection of intellectual property rights may retard the development of Chinese firms in creative industries that would help the PRC climb the development ladder.
- The PRC's rapidly aging population poses additional problems. The lack of a social safety net, along with the limited availability of private retirement plans, consumer credit, and insurance products, drive Chinese households to save prodigiously. The resulting extraordinarily high gross saving rate hampers the PRC's ability to transition from export-led to domestic consumption-driven growth.
- SOEs and SIEs are generally inefficient. Many financially distressed SOEs and SIEs need large subsidies to survive. *Guanxi* loans and policy loans to subsidize financial distressed SOEs and SIEs have been a major cause of the nonperforming loan problem in Chinese banks and other depository institutions. *Guanxi* loans have also encouraged SOEs and SIEs to invest heavily in construction and real estate development. Many of these investments are speculative. A tidal wave of new nonperforming loans in Chinese banks and other depository institutions may now be forming.
- Non-market lending to SOEs and SIEs reduces the amount of credit available to Chinese households and private businesses, lowers the PRC's potential growth rate, and hinders the PRC's transition from export-led to domestic consumption-driven growth.
- An undervalued renminbi creates excess liquidity in state-influenced Chinese banks and other depository institutions. Excess liquidity encourages bankers to lend aggressively. In turn, easy credit encourages SOEs and SIEs that are insulated from price signals and profitability constraints to make speculative investments in fixed assets. The nexus among an undervalued exchange rate, state-influenced Chinese banks, and SOEs and SIEs is apparently creating widespread overinvestment and malinvestment in the PRC. This is especially true in the real estate sector. Such an investment bubble is unsustainable over the long term.
- An undervalued renminbi also fans protectionist sentiment abroad. Protectionism is particularly dangerous for the PRC, whose economic growth has been extraordinarily dependent on exports and foreign direct investment.
- The absence of secure and transferable property rights in agricultural land and the limited availability of credit inhibit Chinese farmers from making the investments in fixed assets necessary to increase low agricultural productivity and raise rural incomes. The wide and growing income gap between rural and urban China is fueling social tensions. Because inefficient Chinese farmers cannot compete with cheaper agricultural imports if the foreign exchange value of the renminbi were to increase substantially, senior officials have resisted any substantial increase in the foreign exchange value of the renminbi. However, this official

reluctance is simultaneously inflating an investment bubble domestically and creating unsustainable imbalances internationally, which together threaten the PRC's rapid economic growth.

Senior officials fear that comprehensive reforms to resolve these interrelated challenges would cause significant economic dislocations and increase unemployment and political unrest in the short run and could weaken the CPC's sway over the Chinese economy in the long run. Consequently, senior officials have responded with incremental policy changes. However, the PRC may be reaching the limits of the effectiveness of its incremental approach to reform.

The PRC must begin to climb the development ladder as Japan, South Korea, and Singapore have done and southeast Asian economies such as Malaysia and Thailand are doing. The distortions from an undervalued exchange rate, non-market lending, overinvestment, and malinvestment – particularly by the SOEs and SIEs and in the real estate sector – are interrelated. The economic imbalances created by these distortions, along with rising disgust at widespread corruption, are fueling social unrest, especially in rural China. Consequently, a more comprehensive approach to solving these problems is needed.

To quell social unrest, the PRC must curb corruption, strengthen the rule of law, and narrow the productivity and income gaps between workers in rural and urban China. To avoid a nasty recession, the PRC must begin to reduce some of the growing imbalances in its economy. Simultaneous reforms of the PRC's agricultural land policies, its financial services sector, and its foreign exchange rate regime are necessary to resolve these festering problems and sustain rapid economic growth.

## **X. CONCLUSION**

Although the Chinese economy is booming, the PRC faces five major challenges to sustain rapid economic growth in the future:

- unfavorable demographics;
- corruption and a weak rule of law;
- financially distressed SOEs and SIEs;
- a dysfunctional financial system; and
- domestic and international imbalances.

The PRC's response to these challenges will, of course, determine the future performance of the Chinese economy. However, since the Chinese economy is so large and well integrated into the global economy, the performance of the Chinese economy will also affect the performance of the United States and other economies in the world.

So far, the PRC's approach to reform has been incremental. This incremental approach may be reaching the limits of its effectiveness. The challenges that the PRC now faces are deeply interrelated. A more comprehensive approach to reform is needed.