

# China's Economic Outlook: Moving Towards a Market Economy

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## **Introduction**

In the early 1800's, Napoleon compared China to a "sleeping dragon" and warned that "when it awakes, the world will shake."<sup>1</sup> China has awoken, and the world has noticed. China's recent development has been truly extraordinary, and its tremendous change has affected many aspects of the global economy.

Consider some facts. Over the past two decades, China's annual rate of real GDP growth averaged over 8% – among the most rapid, sustained, periods of growth observed anywhere. This has lifted China's total output from less than \$300 billion in 1980 to more than \$1.4 trillion today.<sup>2</sup> By the end of 2003 China was the world's seventh largest economy when output is measured using current exchange rates, and the second largest economy using purchasing-power parity rates. China now consumes roughly one-half of the world's cement and one-third of its steel. China is also now the world's second largest consumer of electric power and its second largest importer of oil.<sup>3</sup>

China's rapid economic growth has also led to a dramatic improvement in the lives of Chinese citizens. Faster economic growth is the only way to substantially raise people's standard of living and provide the resources to reduce poverty. In 1980, China's per capita income was approximately \$300 – less than that of countries such as Chad, India, Ghana, and Nigeria. Today China's per capita income has more than quadrupled to about \$1,100—so that China is more than roughly three times as wealthy per person as in Chad, Ghana and Nigeria, and close to levels in countries such as the Philippines.<sup>4</sup>

China's social indicators have also improved significantly. Since the 1970's, average life expectancy in China has risen from 65 to 72 and adult illiteracy has fallen by half. Perhaps the most notable, and most uplifting, has been how China's growth has reduced global poverty. The World Bank reports that China's economic growth has been the single most important factor in countering global poverty since the 1980's.<sup>5</sup> Since 1982, over 400 million Chinese citizens have reportedly been lifted above the global poverty line. During this same period, China's rate of rural poverty declined by 89%.

## **Lessons Learned**

A number of lessons can be learned from China's success. One is the importance of private sector development and the need for governments to help establish an environment with the appropriate incentives and opportunities to help catalyze private sector growth. China's private sector currently produces approximately 55% of the country's total output. This is a sharp

increase from only a quarter-century ago, when virtually all of China's output came from its public sector.

Another lesson is the importance of openness – especially openness to trade and foreign investment. China's recent entry into the World Trade Organization has helped drive its rapid expansion of trade and foreign investment. In 2003, China received almost \$55 billion of FDI inflows. In fact, in the past 2 years China has been the 1<sup>st</sup> or 2<sup>nd</sup> largest recipient of FDI inflows in the entire world.<sup>6</sup>

Openness has also helped contribute to China's rise in global competitiveness rankings. In its most recent "Global Competitiveness Report," the World Economic Forum ranked China as the 44<sup>th</sup> most "growth competitive" economy in the world – ahead of other key emerging economies such as Poland, Mexico, Brazil, India, and Turkey.

Despite these important and impressive accomplishments, significant challenges lie ahead for China. The list of challenges is long—from confronting its environmental challenges, to improving health care systems, to supporting job creation and reducing unemployment, to financing the expenses related to the rapid aging of the population. I will focus on two specific challenges—the immediate challenge of achieving a soft landing and the longer-term challenge of ensuring that this strong growth continues.

### **The Short-Term Challenge: Achieve a "Soft Landing"**

Many economists and Chinese officials have recently been concerned about the possibility of "overheating" in China. Growth in 2003 was reported to be 9.1%—a rate above the official government target (of about 7.0%) and above what is believed to be sustainable in China without generating inflation and shortages. Official figures indicate that yearly CPI inflation through July was over 5%—a sharp increase from the deflation in China as recently as December 2002. Fixed investment, commodity prices, and real estate prices in some cities have increased dramatically, and shortages and bottlenecks have emerged in some sectors. Once inflation begins, it is often difficult to end. Moreover, if investment grows too rapidly and bubbles form in certain sectors, any adjustment can be sharp and severe.

China has faced this challenge of overheating and inflation in the past. During the past quarter-century, China experienced three episodes of overheating – in 1985, 1988-89, and 1993-95. In the first two of these episodes, a sharp increase in inflation was followed immediately afterwards by a rapid slowdown in growth.

When most countries begin to face the risk of overheating, their central banks typically raise interest rates, acting preemptively to slow growth and contain inflationary pressures. This can reduce the chance of an economic "hard landing" and corresponding painful adjustment. Chinese leaders, however, are currently reluctant to raise interest rates. Although there has been some slight easing of interest rate restrictions, officials are mainly relying on administrative controls and central government directives to try to slow growth. Price controls have been expanded. Bank credit is increasingly being rationed. In some cases, spending projects have been cancelled, postponed, or scaled down – often on the basis of political rather than economic considerations.

The U.S. experience of the 1970's and early 1980's provides a useful lesson for China. Inflation in the U.S. increased from 6% in 1976 to nearly 14% in 1980. The U.S. government tried a number of administrative controls to try to rein in inflation—such as establishing a Price Commission that proposed a comprehensive set of price controls. President Ford even started a campaign to “Whip Inflation Now” –also known as the campaign to WIN. All of these measures were unsuccessful at stopping inflation—as well as introducing a whole host of inefficiencies into the economy. The only policy which was able to control inflation was when the Federal Reserve Board raised interest rates sharply in 1981. Inflation immediately fell—from its peak of almost 14% in 1980 to 6% in 1982 to 3% in 1983. Growth also contracted sharply, but the contraction would have been much less severe, and the central bank could have acted less aggressively, if it had not waited so long to raise interest rates. The United States learned a clear lesson that it has followed ever since; raising interest rates is the most effective mechanism to fight inflation.

This U.S. example was far from the first attempt to use price controls to restrain inflation. In fact, there is a long, and often unhappy, history of such efforts. The ancient Babylonian leader Hammurabi reportedly included price controls as part of his famous legal code, a decision that had disastrous economic consequences. In the 4<sup>th</sup> century the Roman Emperor Diocletian decided to sell wheat at fixed rates that were well below market levels – a massive subsidy to control food prices. This led to a sharp deterioration in Rome's public finances, a deterioration handled by the creation of new money which in turn caused rapid inflation.

It is too early to know whether China will be able to engineer a soft landing by using administrative controls and without raising interest rates. The historical experience suggests, however, that the Chinese government should seriously consider an alternate strategy. Granted, in an economy where market mechanisms are more limited than in countries such as the United States, interest rate policy may be less effective and harder to manage. But, even if interest rate policy is less effective than in developed countries, it is still effective and likely to be more effective than the current administrative controls.

There is already anecdotal evidence that some projects that were put on hold due to the administrative controls were just delayed briefly and are already coming back online. There is also evidence that the economy is not slowing as quickly as expected—such as the reported 31% growth (year/year) in fixed investment in July (compared to market expectations of 20% growth). Moreover, the recent increase in inflation makes the need to raise interest rates even more urgent. Since inflation is higher than nominal interest rates, real interest rates are currently negative. In other words, companies can basically borrow money for free. With this incentive, it is not surprising that companies will continue to increase borrowing to expand and undertake low-return projects—a practice which will only further reinforce growing inflationary pressures.

According to Chinese mythology, one characteristic of dragons is that they learn from past mistakes. Hopefully China will adopt this characteristic of its national symbol and learn from its and other countries past mistakes by relying increasingly on market mechanisms rather than administrative controls.

### **The Longer-Term Challenge: Moving to More Market-Based Mechanisms**

As China evaluates what mechanisms to use to attain a soft landing, it should also consider how these policies will affect the longer-term goal of sustaining high rates of growth. Centuries of development have taught us that the best way to sustain high rates of growth is through productivity growth. Michael Porter, an expert on competitiveness, has written extensively about the importance of productivity growth: “A nation’s standard of living in the long-term depends on its ability to maintain a high and rising level of productivity.”<sup>7</sup>

China must continue to develop and strengthen its market mechanisms in order to allocate resources more efficiently and raise productivity growth. Market mechanisms will help to create new opportunities for China’s vast and diverse population. China has already had some success in shifting from a largely state-controlled economy to an economy that is a mix of state-control and market mechanisms. But it must not stop here. As the economy continues to expand, it becomes increasingly more difficult for a government to ensure it functions efficiently. For a country of 1.3 billion people, a land mass of over 9 billion square kilometers, an economy producing \$1.4 trillion per year, and a coastline covering 14,500 square kilometers, a government bureaucracy—no matter how talented—is simply unable to direct production and allocate resources as efficiently as the market.

The current debate about how to best restrain overheating and inflation shows how shifting to more market-based mechanisms will accomplish this goal of raising long-term productivity and growth. Anecdotal evidence suggests that the current use of administrative controls has limited some companies’ ability to obtain financing—but often in inefficient ways. For example, some large, inefficient state-owned enterprises, often with political connections, can still easily obtain loans to fund expansion. Some smaller, private sector companies are simultaneously unable to obtain financing—even though their projects may be highly profitable. The administrative controls are therefore leading to an inefficient allocation of resources, which will lower productivity and growth. Equally serious, a continuation of these practices could lead to a further accumulation of loans by inefficient state-owned companies, loans that are unlikely to ever be paid back. This will place an even greater strain on the entire financial system, increasing the already large financial liability for the government.

In contrast, if interest rates were raised and administrative controls reduced, loans would be more likely to be made based on the expected profitability of the projects. Money would flow to its most efficient use, raising overall productivity and long-term growth. Efficient companies that do not have strong political connections could grow, expand, and hire new workers.

Likewise, shifting to market-based mechanisms in other areas of the economy would also benefit the Chinese economy—such as accelerating its move to a more market-determined, flexible exchange rate regime—a move to which the Chinese government has already committed. A more flexible exchange rate regime would help limit growth in the money supply—which is one of the key factors fueling inflation in China. A more flexible exchange rate would increase the effectiveness of interest rate policy. A more flexible exchange rate would also allow trade flows to adjust to help stabilize overall economic growth.

Another key step in moving toward a more market-based system and higher productivity growth is reforming the inefficient, state-dominated banking system. Although the government has taken

some steps to strengthen the banking system, much more needs to be done. This system currently allocates credit inefficiently, impeding the growth of a domestic capital market. Closely related is the need to rationalize state enterprises. These enterprises consume a large share of public resources, contribute to banks' non-performing loans, and constrain credit available to fund private sector development.

## **Conclusion**

The scale of the challenges that China faces, however, should not diminish its accomplishments. China's development over the past quarter-century is among the most impressive economic achievements that the world community has witnessed.

In Chinese mythology, mountains were likened to sleeping dragons and earthquakes were their movements. Commentators enjoy comparing the emergence of China to these earthquakes—a shaking of the global economy that can have unpleasant consequences. Even when Napoleon referred to China as the “sleeping dragon”, he reportedly followed this with a suggestion that Europe should avoid waking the dragon. But Chinese mythology also believes that dragons have beneficial effects—such as forming clouds with their breath and bringing rain. Similarly, the rest of the world must remember that even though the emergence of China may bring about new challenges, it also offers tremendous opportunities.

That is why it is in the world's interest to see that China continues to improve the standards of living of its citizens through continued strong and sustained growth. And this is most likely to occur if China continues to move toward more market-based mechanisms throughout the economy.

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<sup>1</sup> Lester Thurow, “The New CIO: Exploring Global Paths,” *Optimize Magazine*, June 2004.

<sup>2</sup> International Monetary Fund, *World Economic Outlook Data Base*, April 2004.

<sup>3</sup> The Economist, “The Hungry Dragon,” 2/19/04, and Central Intelligence Agency, *World Factbook – China*.

<sup>4</sup> International Monetary Fund, *World Economic Outlook Data Base*, April 2004.

<sup>5</sup> World Bank, *Economic Achievements and Current Challenges in China*, [www.worldbank.org.cn/english/overview](http://www.worldbank.org.cn/english/overview). Also see Shaohua Chen and Martin Ravallion: “How Have the World's Poorest Fared Since the 1980's?” World Bank Working Paper 3341, June 2004.

<sup>6</sup> See <http://www.uschina.org/statistics/fdi1979-03.html>

<sup>7</sup> Michael Porter, *The Competitive Advantage of Nations*, p. 2.