

Some Observations on the Chinese Economy

A Special Lecture for

Center for East Asian Studies, CCSU

and

Chinese Culture Center (CCC)

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A Chronicle of Modern Chinese History

1912-1949 Republic of China

Dr. Sun Yat-sen proclaims the first Republic in Asia. Emperor's gone, China remains to be a semi-colonial, semi-feudal society. Warlords fight one another. In 1931-1945, China suffered from Japan's invasion, starvations, flooding, epidemics and Civil War thereafter.

1949 - People's Republic of China

1949 Illiteracy rate 57%; power capacity 1,850MW (4% US); essentially no modern industry.

1950 Per capita GDP \$439 (India \$619; US \$9,561) in 1990 international dollars.

1950-53 Korean War, according to General Omar Bradley: "The wrong war, at the wrong place, at the wrong time, and with the wrong enemy." (5/15/1951 US Congressional testimony)

1959-1961 Great Leap Forward, widespread famine results in millions of premature deaths.

1966-76 Cultural Revolution, a disaster!

1978 Deng Xiaoping (1904-1997) decentralizes economic power, starts the Reforms and Openness policy and creates an average of 9.8% of GDP growth for 30 years.

1989 Despite sanctions after Tiananmen Square repression, Reforms and Openness continues.

1997-8 Asian financial crisis; China keeps RMB (¥) stable and started banking system reform.

2008 5/12 Sichuan earthquake, about 70,000 people die.

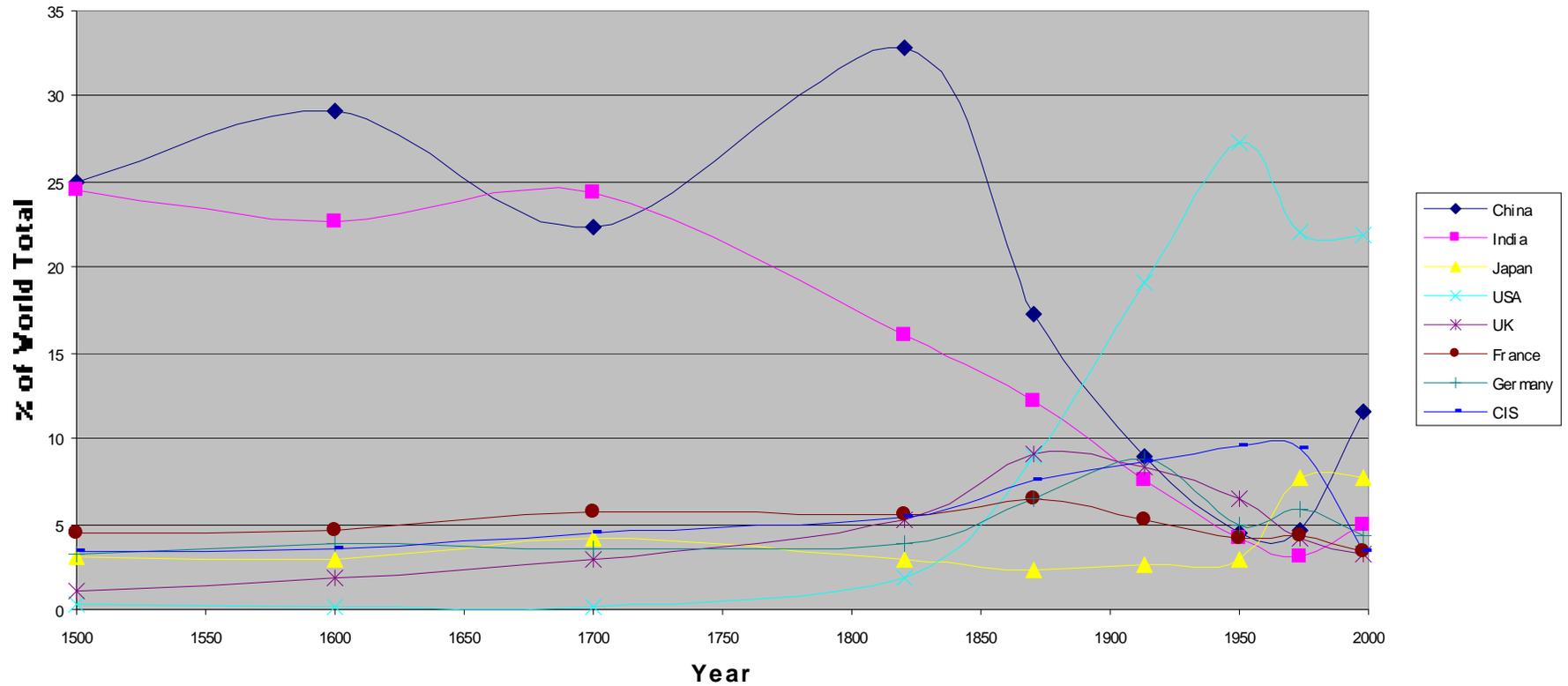
8/8-24 Beijing Olympics.

9/27 China's first spacewalk

Illiteracy rate 9% (2000 census); power capacity 760,000MW (est; 411 times of 1949)

Shares of World GDP based on Purchasing Power

Source: Angus Maddison, "The World Economy: A Millennial Perspective," OECD 2006



Recent Economic Data for United States and China

Macroeconomic Data	Unit	China	United States	China/US	Remarks	Sources
Population	million	1,338.6	307.2	436%	July 2009 est.	CIA World Factbook
Urbanization	%	44	82	54%	2007/2008	NBSC/CIA World Factbook
GDP (PPP)	\$ trillion	7.8	14.29	55%	2008 est.	CIA World Factbook
GDP (exchange rate)	\$ trillion	4.3334	14.2000	31%	2008	Xinhua 3/5/2009 / BEA
GDP (world share)	%	7	23	31%	2008	Xinhua 3/5/2009
PerCapita GDP (PPP)	\$	5,827	46,517	13%	2008	
PerCapita GDP (PPP)	\$	6,757	41,890	16%	2005	UN Human Development Report
PerCapita GDP (exchange)	\$	3,237	46,224	7%		
GDP growth (2008)	%	9.00	1.13	796%		Xinhua/Global Economics Research
GDP growth (Q4, 2008)	%	6.80	-6.30			Xinhua/BusinessWeek 4/27/09
Unemployment Rate	%	9.4	8.5	111%	4.2 - 9.4%, Mar 2009	MHR&SS; CASS/US DOL
Inflation	%	5.9	0.1		2008	China CPI/US Labor Dept
CPI - seasonally adjusted	%	-1.6	0.4		Feb-09	All China Data/US DOL
Gini Index		47	45		2007 est.	CIA World Factbook
National Debt	% GDP	20	79		12/31/08; 4/7/09	ZhongXinWang/Gold World
Literacy	%	91	99		2000 census/03 est	China's 2000 Census/ CIA
HDI Ranking		94	15		2008; 179 Countries	UN Human Development Report
Power Generation Capacity	MW	713,290	1,031,978	69%	2007	Xinhua(chinaequip)/US EIA
Electricity Production	Trillion k Wh	3.256	4.167	78%	2007	CIA World Factbook

Driving Forces Behind Fast Growth in Last 30 Years and Beyond

- Government, Stability & Opportunity – Communist party continues to monopolize political powers. Economic reform precedes political therapy: trial and error approach (摸着石头过河); “controlled” privatization. Chinese, more than anyone else, needs social stability & development opportunities and government provides both.
- Fear of poverty (穷怕了) and Entrepreneurship – Guangdong model (广东模式), Wenzhou model (温州模式) & Alibaba model.
- Confucianism and Work Ethic – hardworking, strong sense of duty & discipline, seeking harmony, respecting knowledge and intellectuals etc.
- Contributions from Overseas Chinese in ASEAN, US and Europe.
- Urbanization – from 18% (1978) to 44% (2007). When can it reach 75%?
- Demographic bonus to claim up to 2020 with a rising share of working age people in 1.3 billion population - Thanks to “one-child policy”, a demonized term. Farewell, Malthusian catastrophe ! (“The power of population is indefinitely greater than the power in the earth to produce subsistence for man.” Thomas Malthus 1798. Subsistence today means more than food, it also includes hygiene, environment, education and development.)

Financial Crisis – The Decline and Fall of Banks

Top 10 Banks in the World by Market Capitalization							
1999				As of 3/23/2009			
	Bank	Country	Mkt Cap (\$b)		Bank	Country	Mkt Cap (\$b)
1	Citigroup	US	150.9	1	ICBC	China	175.3
2	Bank of America	US	112.9	2	China Construction Bank	China	128.7
3	HSBC	UK	93.7	3	Bank o China	China	112.8
4	Lloyds TSB	UK	72.0	4	JP Morgan Chase	US	94.5
5	Fannie Mae	US	69.6	5	HSBC	UK	78.3
6	Bank One	US	66.8	6	Wells Fargo	US	62.1
7	Wells Fargo	US	66.1	7	Mitsubishi UFJ Financial	Japan	56.2
8	UBS	Swiss	63.4	8	Banco Santander	Spain	54.1
9	Bank of Tokyo-Mitsubishi	Japan	61.8	9	Goldman Sachs	US	45.7
10	Chase Manhattan	US	61.1	10	Royal Bank of Canada	Canada	40.3

Source: Steven Bernard et al "The Decade for Global Banks," Financial Times 3/22/2009; World Journal 3/24/2009

2008 Performance of Chinese Banks				
Bank	Net Profit		ROIC	
	¥ b	\$b	% growth	%
ICBC	111.20	16.26	35.20	
China Construction Bank	92.64	13.54	34.00	
Bank of China	64.36	9.41	14.42	
Communication Bank	28.93	4.23	40.05	
Overall	583.40		30.60	17.10
ROIC = Return on Invested Capital, a lagging indicator				
Source: finance.people.com.cn 4/13/2009				

Lessons Learned

- A dramatic shift in banking c.g. amid the financial crisis and severe decline in equity markets.
- Root Causes: overspending, slack regulation, over-leveraged investments and greedy executives - "English-speaking capitalism on trial in G20 Summit" as Times claimed?
- Financial crisis does not exist in China and in fact its banking system even getting stronger in 2008. Still it suffers badly from collapse of export-oriented enterprises when foreign demand shrinks.
- Tim Geithner acknowledged that "We bear a substantial share of the responsibility for what has happened....We must set ourselves on a path so that one country, or group of countries, does not consume in excess while another set of countries produces in excess." (A speech to the Economic Club of Washington, Reuters 4/22/09)

What is a Crisis?

危机 = 危险 + 机会

Crisis = Danger + Opportunity” (literally translated)

In every crisis lies an opportunity.

What can the Government do?

Government's Responsibility:

Maintain high level of growth and employment while keep inflation low.

Government's Macroeconomic Instruments:

1. Monetary policy: Central Bank (Fed Reserve) controls money supply, determines interest rates. To increase market fluidity, the current US prime rate of 3.25% (Fed funds rate 0.25%) is the lowest since 1954 (record high: 21.5% 12/19/80 – 1/2/81).
2. Fiscal policy: Through government expenditures (purchases & transfer payments) and taxation to help business running smoothly.

About these 2 Keynesian approaches, leading economists have their arguments:

1. Boost expenditure and cut taxes to fight economic downturn – P. Samuelson; P. Krugman
2. Use monetary policy; massive stimulus unlikely to work over time – M. Friedman; R. Lucas Jr.

China announced its “active fiscal policy and moderately easy monetary policy” on 11/9/08. It adopts both instruments, but more toward stimulus plan.

China's interbank offered rate (equivalent to Fed funds rate) is 0.8% ; and home mortgage rate is 5.94% (equivalent to 30-year fixed-rate in US which is about 5.01% APR).

A Note on China's GDP

4 Components of Gross Domestic Product

$$\text{GDP} = \text{Private Consumption} + \text{Government Spending} + \text{Gross Investment} + \text{Net Export} \\ = C + G + I + \text{NX}$$

China's GDP by Components (%)

Year	C	G	I	NX	Growth
2006	33.80	12.78	46.40	7.03	11.1
2007	32.27	12.15	47.49	8.09	13.0 (revised from 11.9)
2008					9.0 (preliminary)

Sources: 2007, 2008 China Statistical Yearbook, National Bureau of Statistics of China (NBSC)

A typical US GDP composition is C: 70%, G: 19%, I: 16%, and NX: -5%.

China's Export Dependency

Jonathan Anderson , “An Old Chinese Myth” Economist, 1/3/2008

Contrary to popular wisdom, China's rapid growth is not hugely dependent on exports.



How China Counteracts the Crisis?

1. Boost domestic demand – Expedite a ¥ 4t (\$584.8b) stimulus package on 11/9/08. Target: “To protect 8% GDP growth” for 2009.
2. Identify, restructure, promote 10 Key Industries – steel, auto, machinery, IT/electronic, textile, petrochemical, non-ferrous metals, shipbuilding, light industry, and logistics.
3. Increase fixed-asset investment – new freeways, high-speed rails, nuclear power plants, power grid rebuild particularly in countryside, low-income housing etc.
4. Welcome home – Attracts Wall St, London Square Mile, and CME elites.
5. Buy natural resources – e.g. Chialco’s \$195b Rio Tinto bid, Russian oil pipeline project.
6. Buy technology and inject more money to expand R&D.
7. Sharpen your skill – e.g. Guangdong province quadrupling its vocational training for 4 million workers to a 3-6 month program.
8. Goal: Make China even more competitive than it was before!

Boost Domestic Demand

- China has heavily relied on investment and export. Before this crisis, export contributed to about 10% of GDP, but slumps now. Private consumption accounts for only 33%.
- Huge private savings reach \$3.18 trillion (bank deposits \$6 trillion; 1/22/09 NBSC).
- Home appliances go to the countryside (家电下乡) – Government-funded project to expand sales of electric appliances in rural area at 13% discount price.
- Subsidize farmers to buy auto, PC & motorcycle by slashing 50% sales tax.
- Local governments offer travel coupons to attract tourists (Hangzhou), coupons for low-income families (Chengdu).
- SME financing – small and medium enterprises account for 65% GDP, provides jobs. But SME is underserved, a world-wide problem. China's BRC is pushing banks to build mechanism, step up loan assessments, reinforce risk monitoring and control.

Green Technology – A Case Study (1)

BYD (比亚迪 Build Your Dreams; HK 1211; 2008 revenue \$39.2b up 26%; net profit \$149m down 37%; market cap \$1.63b as of 4/21/09)

- Founded in 1995; 120,000 employees.
- Used to produce rechargeable battery and handset components.
- Bought 2 established automakers in 2003.
- World's 1st mass-produced plug-in hybrid car F3DM on sale in China on 12/15/08 (about \$22,000 each; equipped with a 1.0 liter gas engine; lithium-ion-phosphate (LiFePO₄) battery; fully recharged from a wall outlet in 7 hrs; 50% recharged at a special station in 10 min; 60 miles range with electric mode).
- Vows to enter the US market by 2011 (by bringing in a bigger 250 miles range with electric mode), become No. 1 carmaker in China by 2015, and No. 1 in the world in 2025.
- Warren Buffet invested \$230 million to take 9.9% of the firm last September.

Green Technology – A Case Study (2)

- Tech problems – 60 miles of range with electric mode only if speed under 31 mph; high rate of battery defects; supporting infrastructure (charging stations and services).
- Low speed and short range of hybrid's electric mode (for all-electric cars BYD to launch, the max speed of 60mph, range between charge of 120 miles) are less of a problem because intercity driving is rare and traffic jams force commuters slowing down.
- Price hurdles - Expect to bring price down to \$15,000 when production is scaled up. However, only hundreds of F3DM have been sold to government and conglomerates. A catch 22?
- Strategy – Seems to use profits from low-end car sales (e.g. less than \$5,000 for a BYD's F0) to support the development of hybrid and all-electric cars.
- Government will subsidize up to \$8,800 per hybrid or all-electric?

(Sources: Investors' News 4/20/09; byd.com.cn; investing.businessweek.com; BBC News 12/13/08; New York Times 12/18/08, 1/12/09, 4/1/09; gm-volt.com)

Why 8% ? China's Unique Problem

- 30 years of experience has shown that the 8-11% growth rate is proper for a sustainable development.
- Over 11% growth induces high inflation.
- Below 8% cannot create enough jobs for expanding labor force.
- In 1980s, China's population increased by about 15millions per year.
- A world-class puzzle China is facing:
In 2009, 24 million people are looking for jobs. Among 6.1 million new college graduates, only 35% have found one (up to Feb 28). Many migrant workers return to home villages to start their small businesses, receive training, or pick up their hoes.

Stumbling Blocks to China's Development (1)

- Inequality in Distribution of Wealth – Gini index reaches 47, a warning message!
- Social Security and High Savings - China doesn't have a nationwide social security system. Local social insurance agencies and employers adapt Government guidelines to local conditions. Coverage for urban employees, self-employed, migrant workers is different. Farmers are mainly through family, community or state financial support. A poor safety net forces Chinese families to save heavily.
- Household (Domicile) – A system that divides farmers from urban residents causes social inequality, particularly the access to employment, healthcare and education. Government has started to remodel or even abolish the system. Recently, more funds have been directed to countryside.
- Healthcare Reform announced on 4/6 is a long awaited move after over 15 years of debates and flip-flops. Since “illness-induced poverty” keeps haunting China and government has high fiscal surplus (\$173.7bn on 10/8/08, but situation may reverse), it's good time to take action. The plan will expand basic healthcare to cover 90% of the population by 2011. Central and local governments have to pump in ¥ 850bn (\$124bn) in 3 years.

Stumbling Blocks to China's Development (2)

- Corruption and Political Reform – Bribery, embezzlement and extortion are haunting China. Ineffective anti-corruption campaigns catalyze “manpower search engine” (人肉搜索). More institutional reform and media monitoring are required.
- Pollution and Environmental Protection – Education campaigns have built consensus but may take at least a generation for environment to recover. Chinese knows we must not repeat the old pattern of pollution first and environment control second. A humongous job!
- Education – Solid training for young generation up to college level. Need to nurture more creativity and innovations.
- R & D Spending – 2006 China's \$136b (4.3% GDP) still low compared to US \$343 (2.6%), EU \$231 (3.2%). Still weak in basic research and such fields as pharmaceuticals, materials and microelectronics.
- **China has most problems in the world and always moves ahead with problems.**

Will China first recover from the crisis? (1)

Q1 Money Supply (Xinhua 4/16/2009)

M1 (currency + checking deposit) ¥ 17.65t (\$2.58t); +17.04% y-o-y, +6.41% from Feb.

M2 (M1 + savings, money market deposits et al) ¥ 53.06t (\$7.76t); +25.51% y-o-y, +5.11% from Feb.

Foreign Exchange Reserve: \$1.9537t Loan growth exploded ¥ 1.89t (\$277b)

There is ample market liquidity.

Q1 GDP + 6.1% (C+G=4.3%, I=2.0 or 6%, NX= - 0.2 or -4.2%)** **US: -6.1%**

CPI -0.6% (J +1.0%, F -1.6%, M -1.2%) y-o-y

PPI -4.6% (J -3.3%, F -4.5%, M -6.0%) y-o-y (crude oil price plummet)

Fixed-asset investment grew 28.8%; Industrial Output up 5.1%

Import/Export - Q1 total \$428.7(-24.9% y-o-y); trade surplus \$62.3b

Jan total \$141.82b (-29 % y-o-y) ; trade surplus \$39.05b (102 % y-o-y)

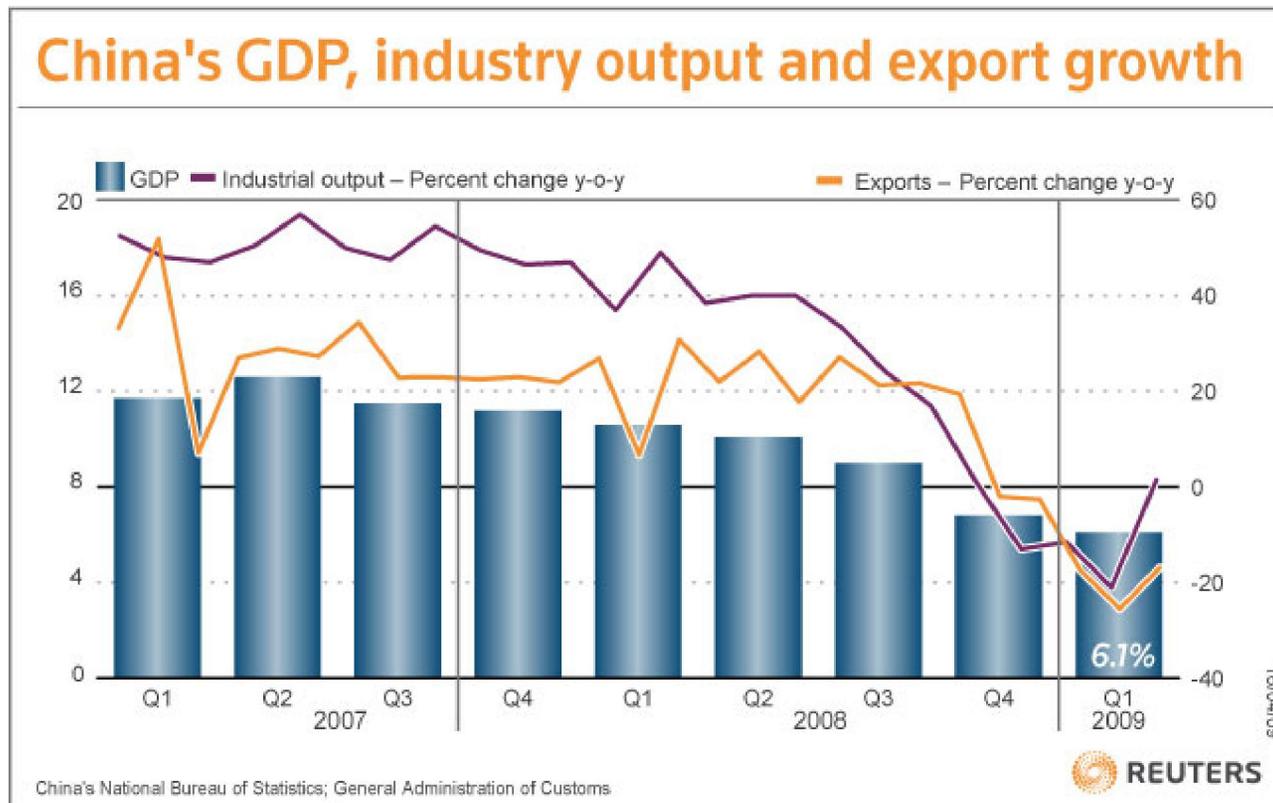
Feb total \$124.95b (-24.9% y-o-y) ; trade surplus \$ 4.84b (-43.5% y-o-y)

Mar total \$162.02b (-20.9% y-o-y) ; trade surplus \$18.56b (41.2% y-o-y)

Import/Exports continue falling but started March are at slower pace.

** China Times 5/5/2009; A set of questionable data to be double-checked!!

Will China first recover from the crisis? (2)

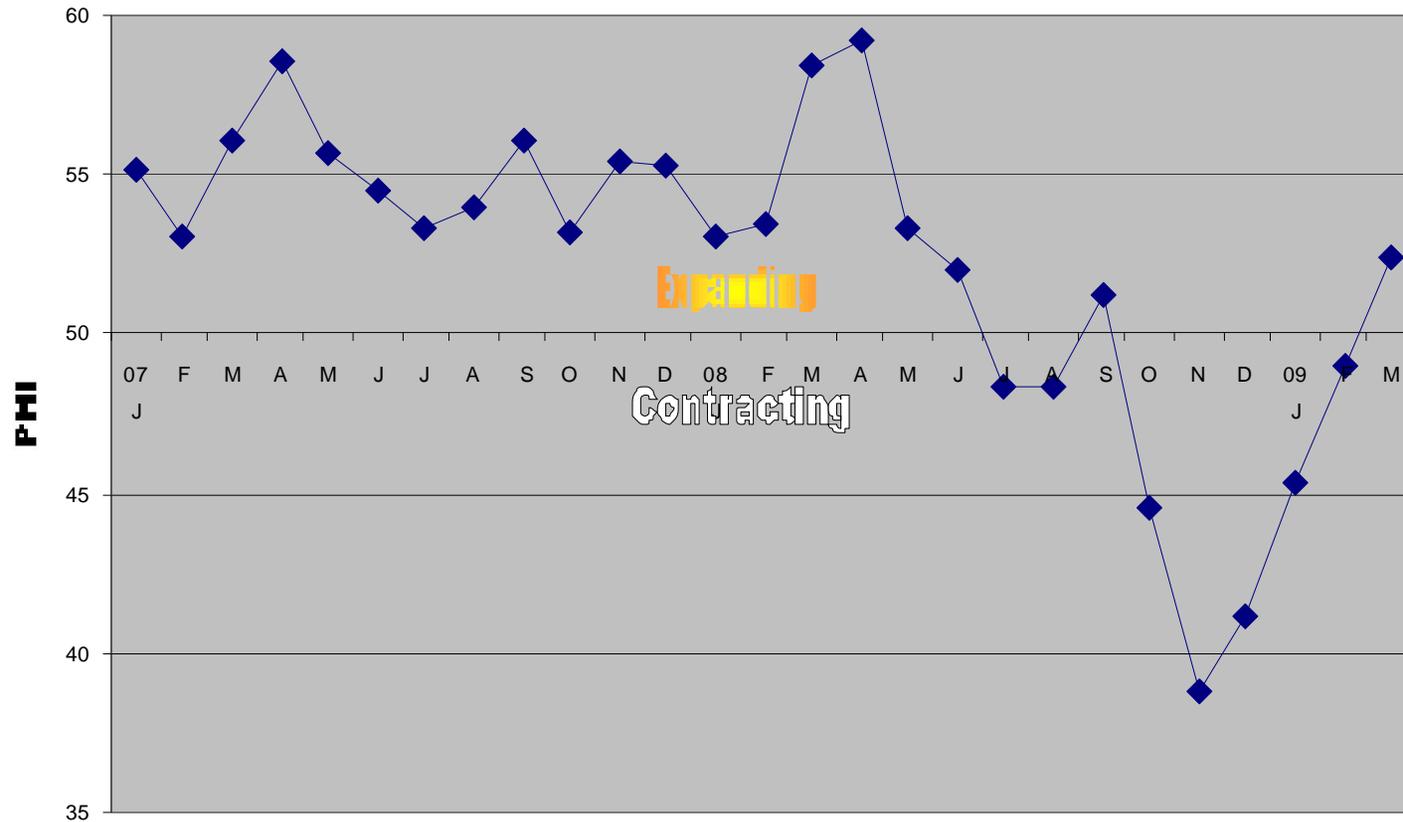


Reuters graphic/Catherine Trevethan

Note: The quarterly growth figures for 2007 do not reflect revisions to full-year growth issued by the National Bureau of Statistics.

Will China first recover from the crisis? (3)

China's Manufacturing Purchasing Managers' Index (PMI)



Will China first recover from the crisis? (4)

- **March: 772,400 cars sold, up 27% m-o-m or up 10% y-o-y. China may top US in Q1 to become the world's largest auto market.** (Xinhua 4/9/09)
- **Stocks: Q1 SSEC Index up 30%, DJI -13%, Nikkei -8%**
(YTD 4/24: 34%, -8%, -2%).
- **Export is the only drag on growth that government cannot revive, but the drop is narrowing down.**
- **CASS: China's 2009 GDP grows by 8.3% vs world's growth rate of 0.5%.**
(chinareviewnews.com 4/21/09)
- **China's economy most likely is bottoming out; the stimulus is paying off.**

Aftermath Scenarios

- Assume US grows by an average rate of 2% and China by 6% , it would take about 30 years, that is AD 2040, for China's GDP (exchange rate) to surpass the US'.
- And, even it happens, China's per capita GDP then is only ¼ of the American.
- Hillary Clinton: “The US-China relationship is the world's most important of the 21st century. The relationship between the United States and China will shape the 21st century.” (CNN & Sky News 2/21/2009, Beijing)
- In fact, United States and China, now and always, need each other.
- President Obama said United States “is not and will never be at war with Islam,” as he addressed the Turkish parliament, sought to bridge divides between the two great civilizations. (FoxNews.com 4/6/09)

Concluding Remarks

- China most likely will first recover from the crisis by summer. China cannot save the world but will make significant contributions.
- China doesn't need more bloodshed and tears. Chinese, like you and me, needs a peaceful environment to prosper, to bring up their children and pay mortgage. China still has long way to go, probably a century, before returning to its historical heights.
- Clash of civilization (as claimed by Prof. Huntington) is a nightmare of mankind and must be prevented. A harmonious world relies on international cooperation and reconciliation in political, economic among other affairs. United States and China have best opportunity to serve as role models.
- Cool heads but warm hearts (Alfred Marshall, 1925) and less ideological shackles are better off in public policy discussion and debate.



RMB Internationalization - A Quantum Jump

- Triffin Dilemma - USD as an international reserve currency must both **overall** flow out of the United States (to provide liquidity), but must also flow in to the US (to keep USD strong). That is, the United States cannot maintain the value of USD while providing liquidity to the world. It is the fundamental problem of the USD's (and any national currency's) role as reserve currency in the Bretton Woods System.
- Although RMB is widely circulated in neighboring countries, it is not yet an international reserve currency. RMB is convertible under current account but only partly convertible under capital account. To participate in world cooperation and competition, complete convertibility of RMB is an issue China has to face.
- China's proposal for International Monetary System Reform. Eventually creates a super-sovereign reserve currency. Short term goal is to put SDR into full play. At present, SDR is only used between governments and international institutions. China promotes the use of SDR in international trade, commodities pricing, investment and corporate book-keeping. This will greatly reduce risks of currency exchange in international trade.
- It has taken 30 years for Euro to come into this world since R. Mundell laid the groundwork, nobody expects a new reserve currency to appear overnight.
- **Recently, China signed agreements with South Korea, Malaysia, Belarus, Indonesia, and Argentina for bilateral currency swap.**

The Monetary Transmission Mechanism

- **Say, during recession, Fed Reserve wants to boost GDP output:**

The Fed increases bank reserves → Money supply in the money market up →

Interest rate down → I, C, NX (weaker \$) all up → Aggregate demand up

→ GDP & Inflation up