

Challenges in Solving Structural Problems in Chinese Economy

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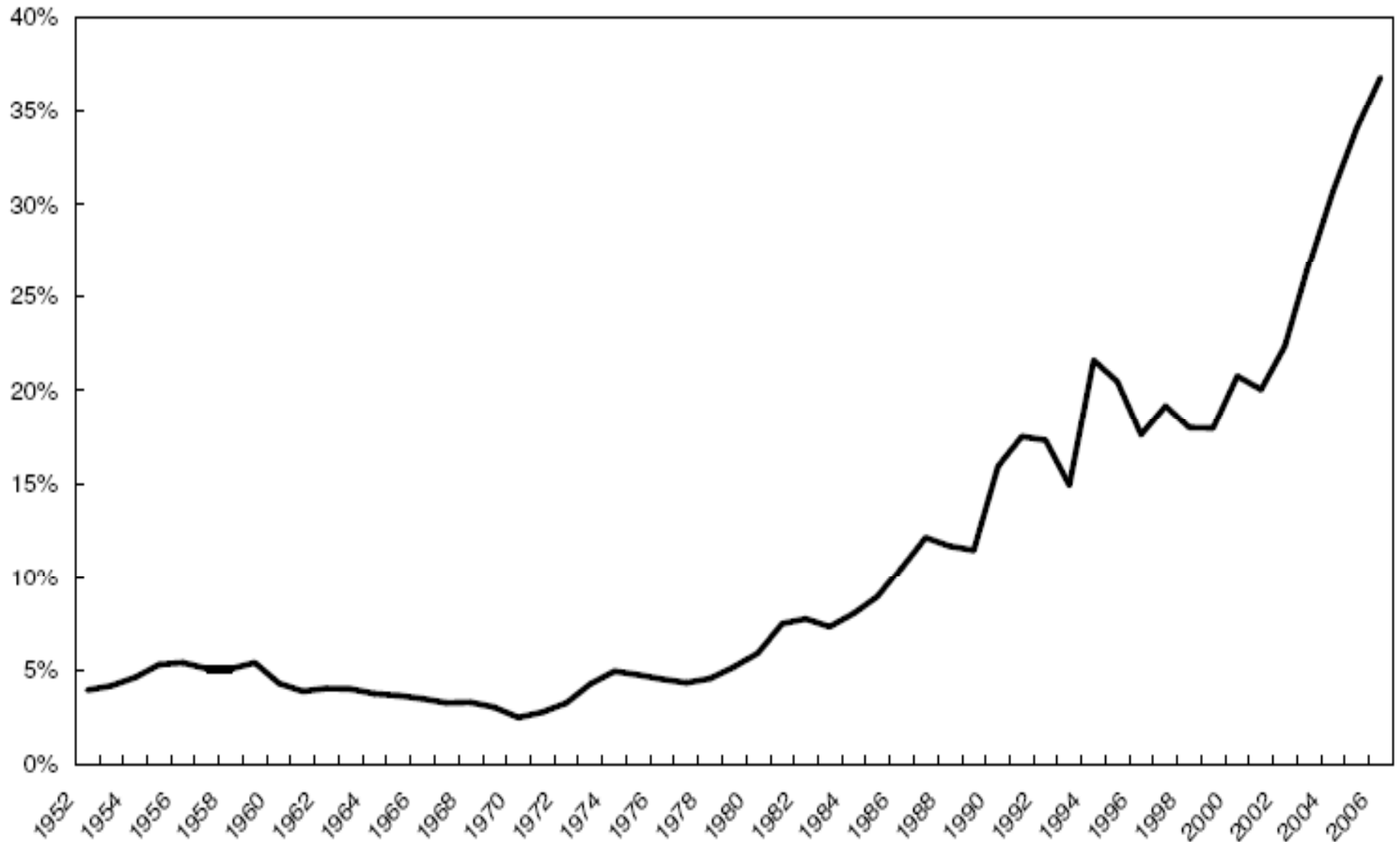
Major Structural Problems:

Stability/sustainability of Chinese economy

- As the 2nd the largest economy (soon may be the largest), export driven growth model is unsustainable
 - Domestic demand is too low: Chinese consumption to GDP ratio is lower than that of any major country in the world
 - Growth of Chinese household income has been slower than the GDP growth rate
- Rapid worsening social-economic inequalities and social injustice (e.g. land appropriation by the government) threaten social stability and growth sustainability
- Concerns on the sustainability of the manufacturing sector
 - Worsened conditions for entry and expansion of small/medium enterprises
 - Worries on slow technology upgrading and on rising labor costs
- Environmental protection issue becomes more urgent

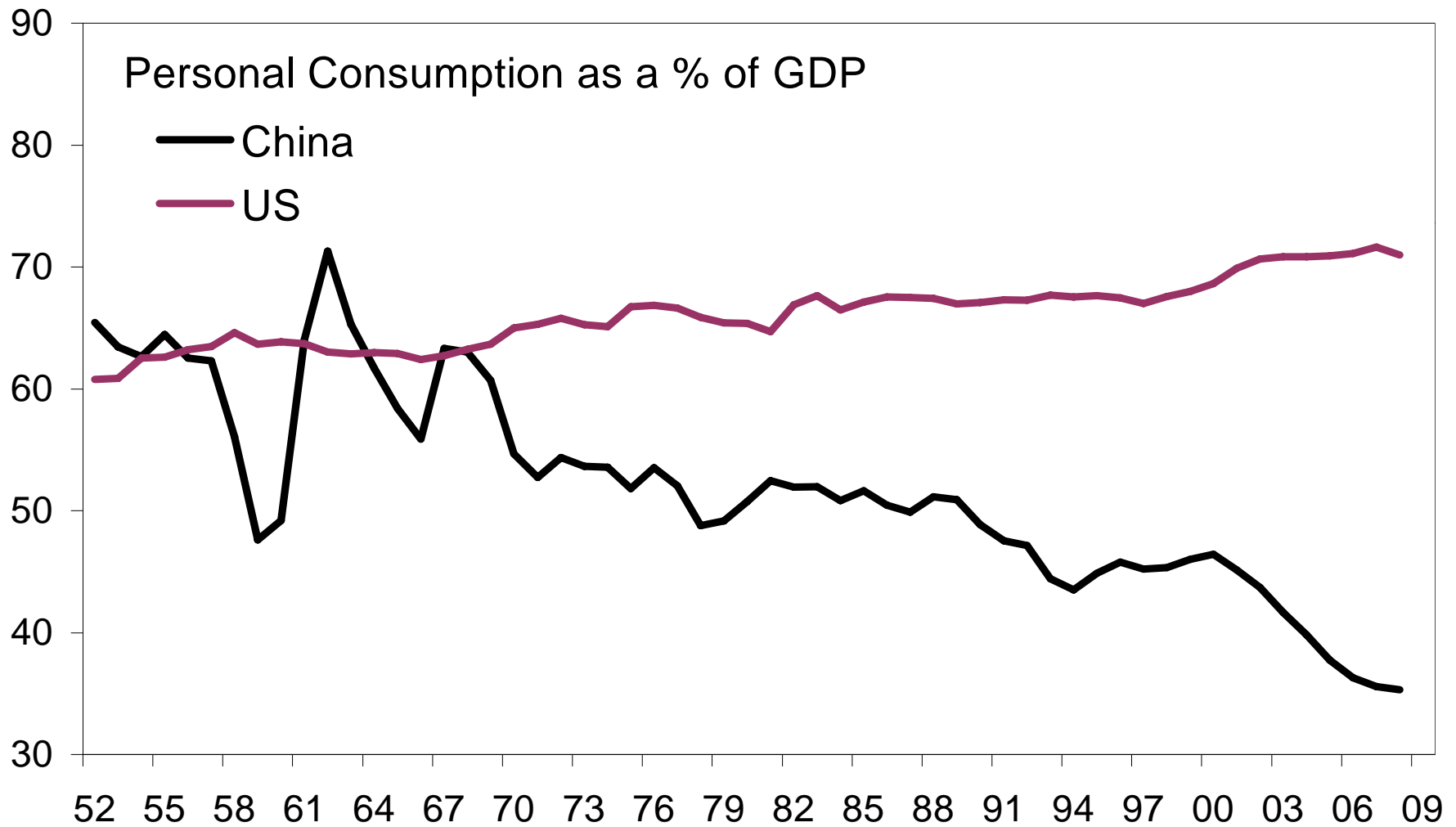
Unsustainable export level

Export over GDP ratio, 1952-2006 (He & Zhang, 2009)



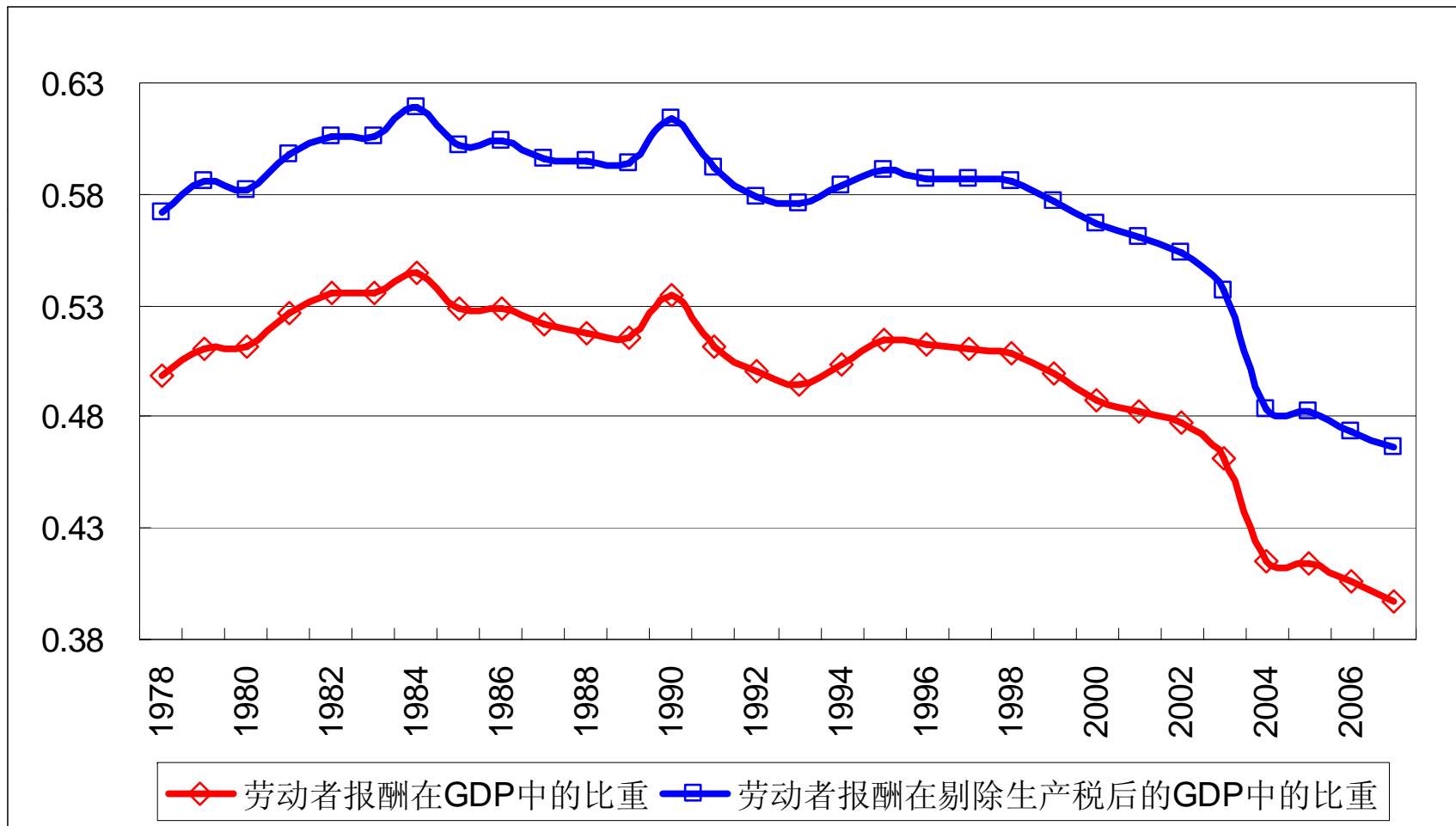
Unsustainable low domestic consumption

Household consumption over GDP ratio: US vs. China, 1952-2009
(Roach, 2009)



Unsustainable low labor income

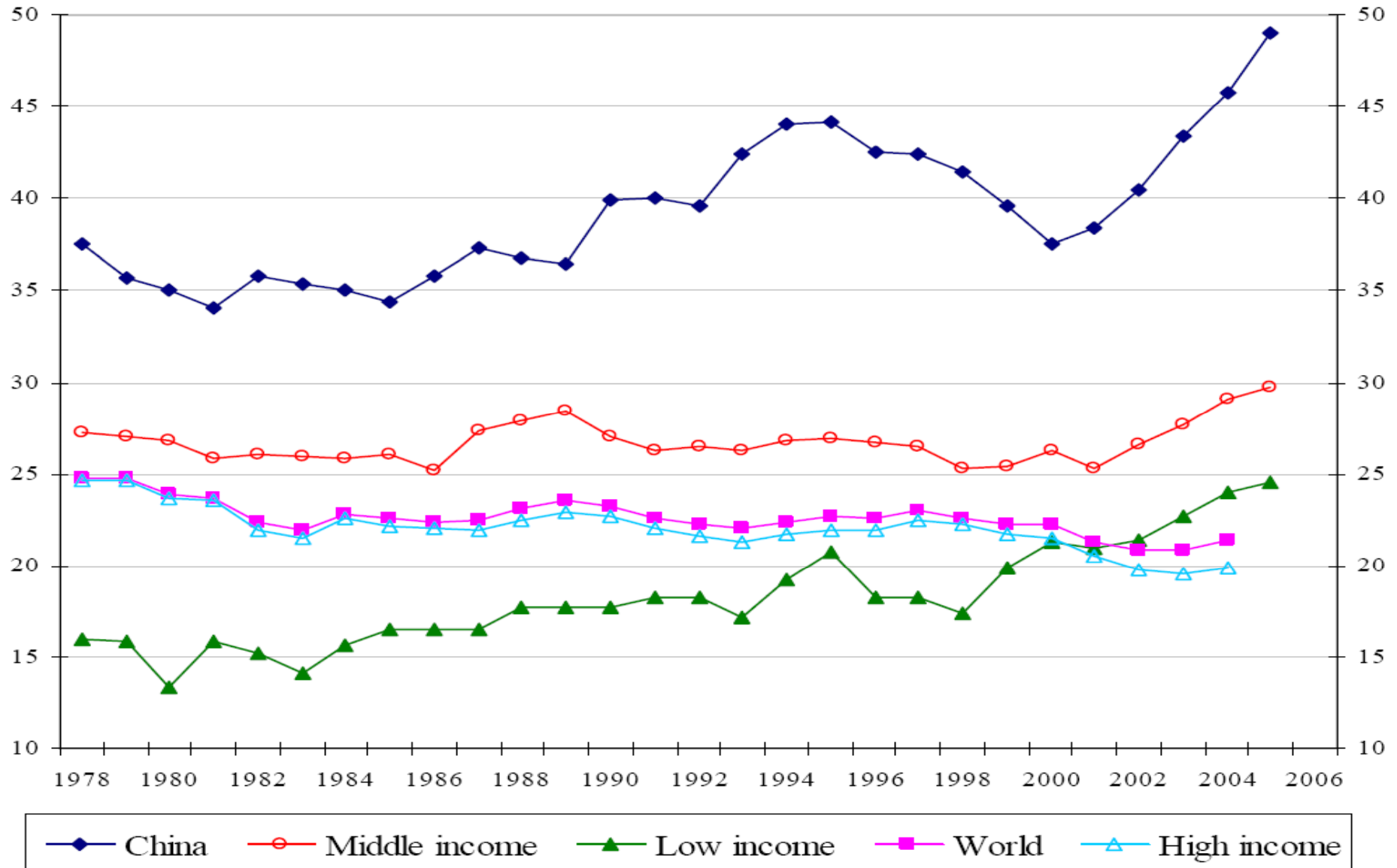
Declining labor income over GDP ratio, 1978-2006 (Bai, 2009)



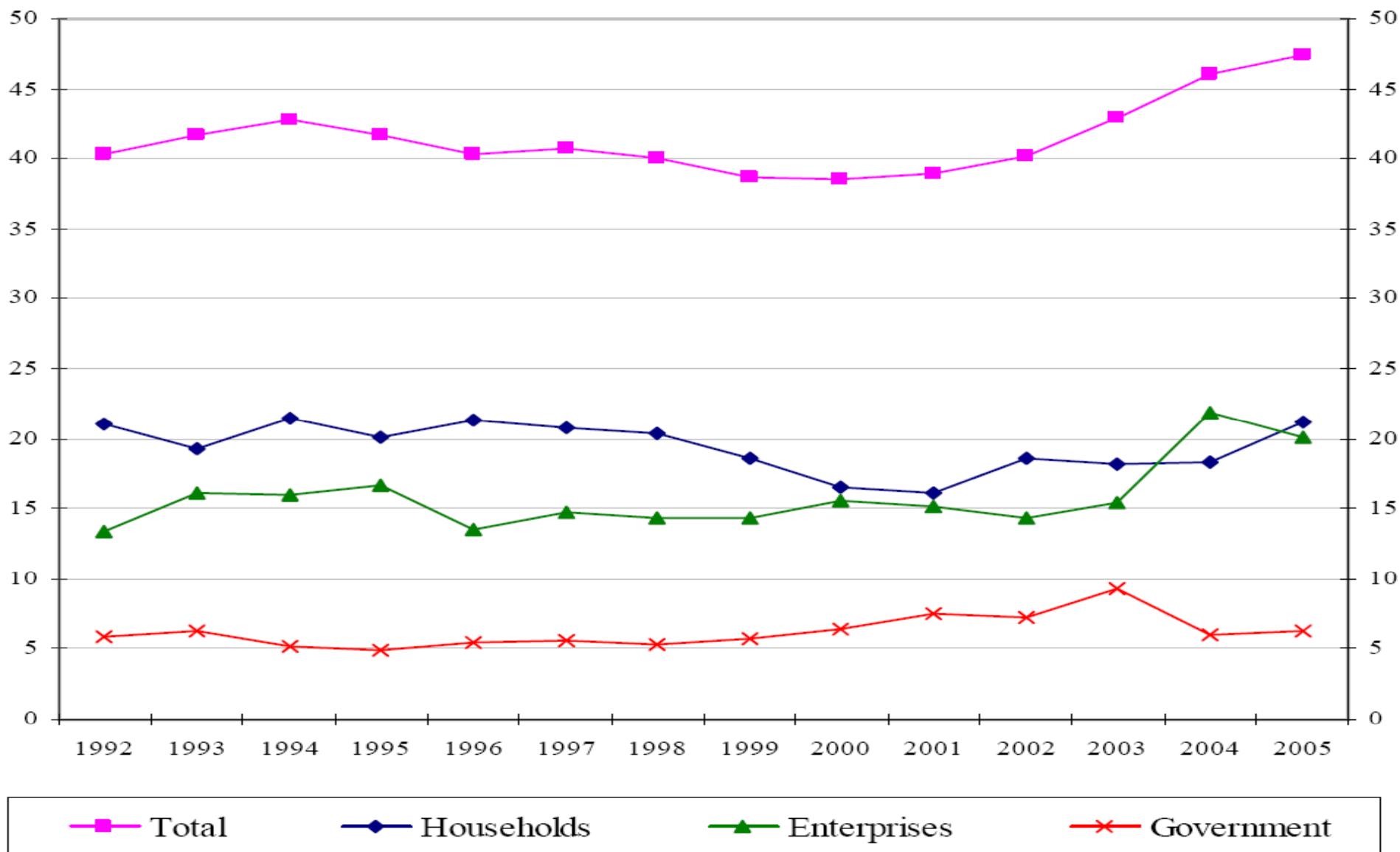
Unsustainable high saving rate

China vs. the rest of the world, 1978-2006

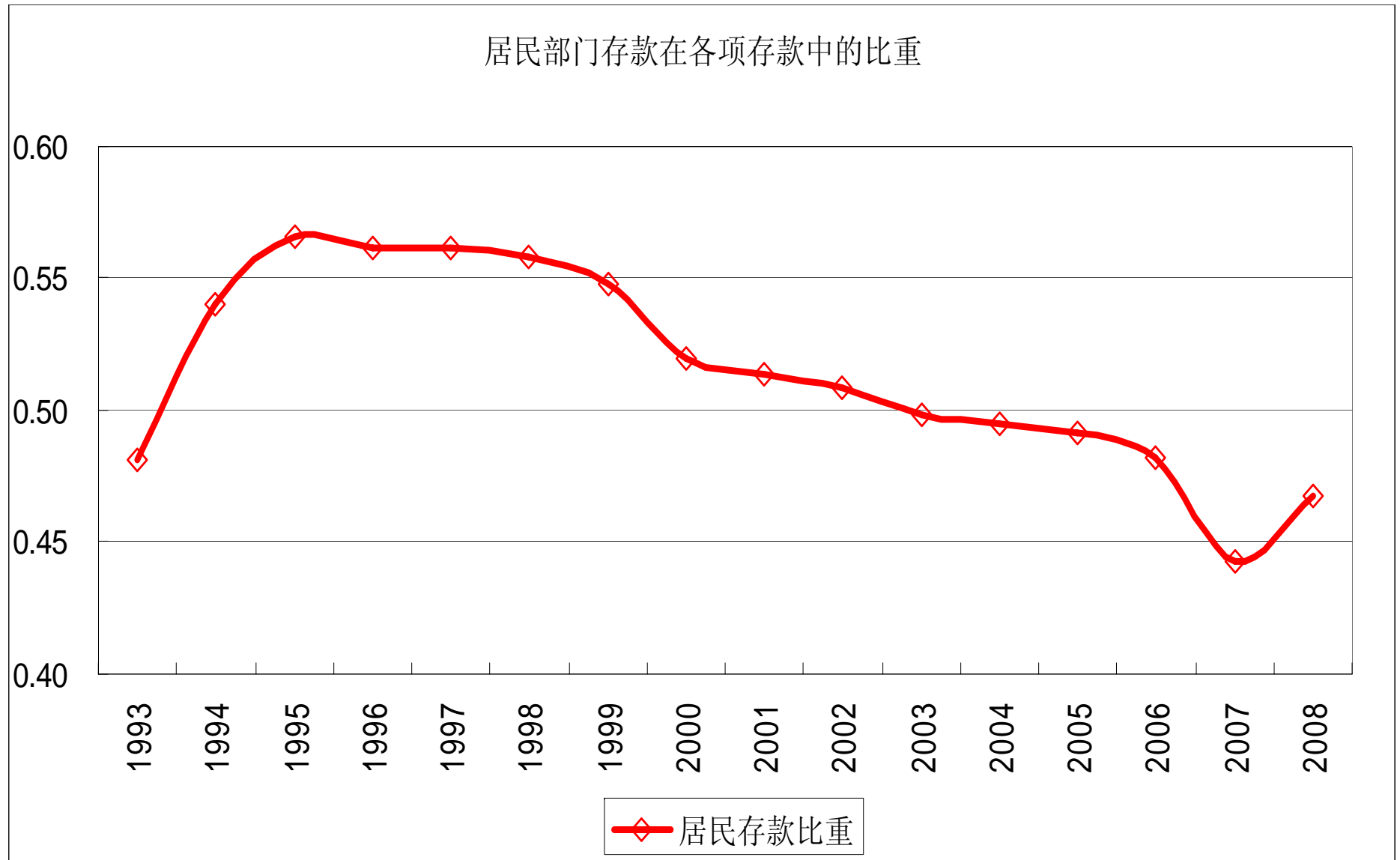
(Yang, Zhang and Zhou, 2009)



Too much enterprise and government savings, 1992-2005 (Yang, Zhang and Zhou, 2009)

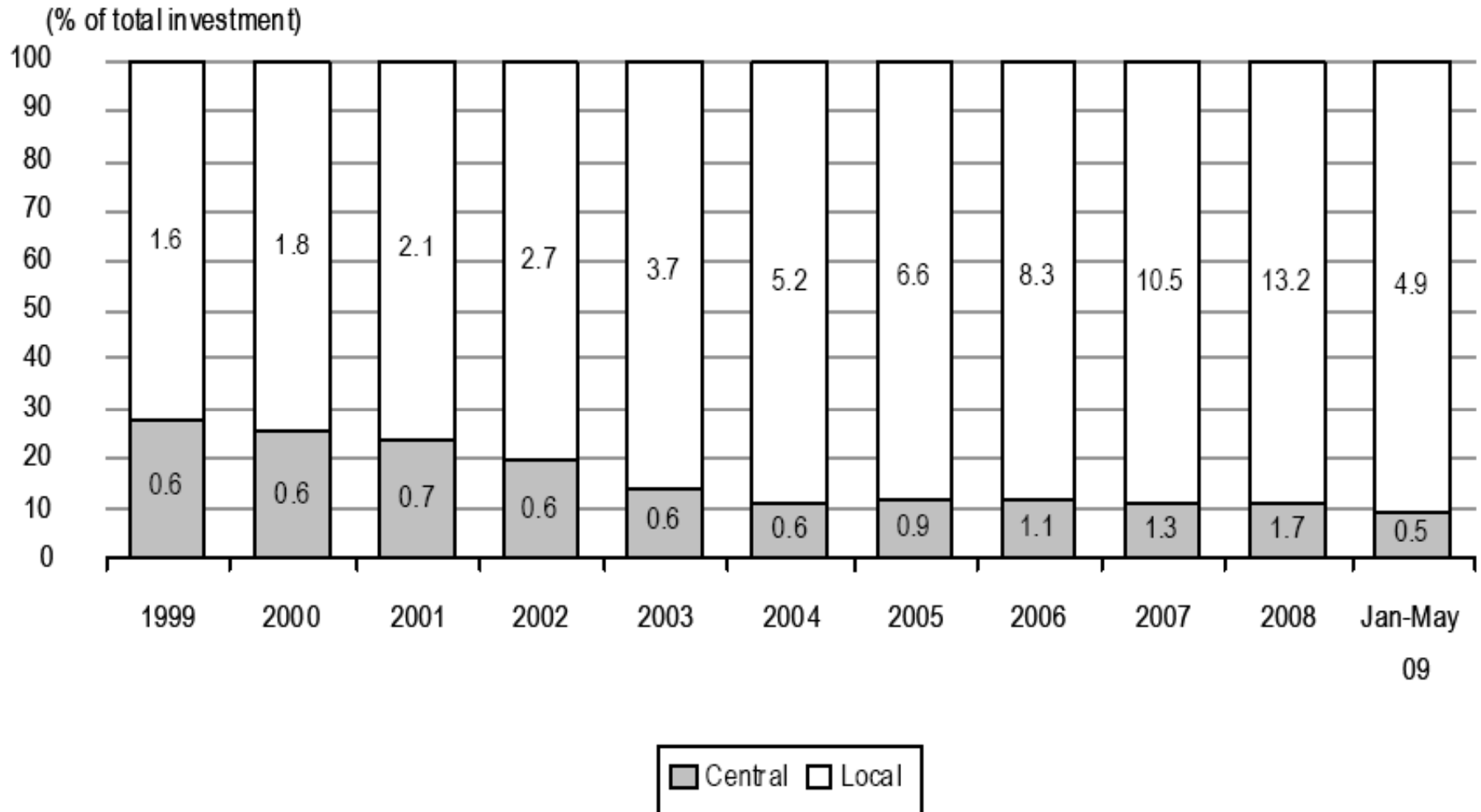


The share of household saving in national saving has declined substantially, 1993-2008 (Bai, 2009)



Most government investments in China are local government investments

The share of central government projects in total declined from 28% to 10%

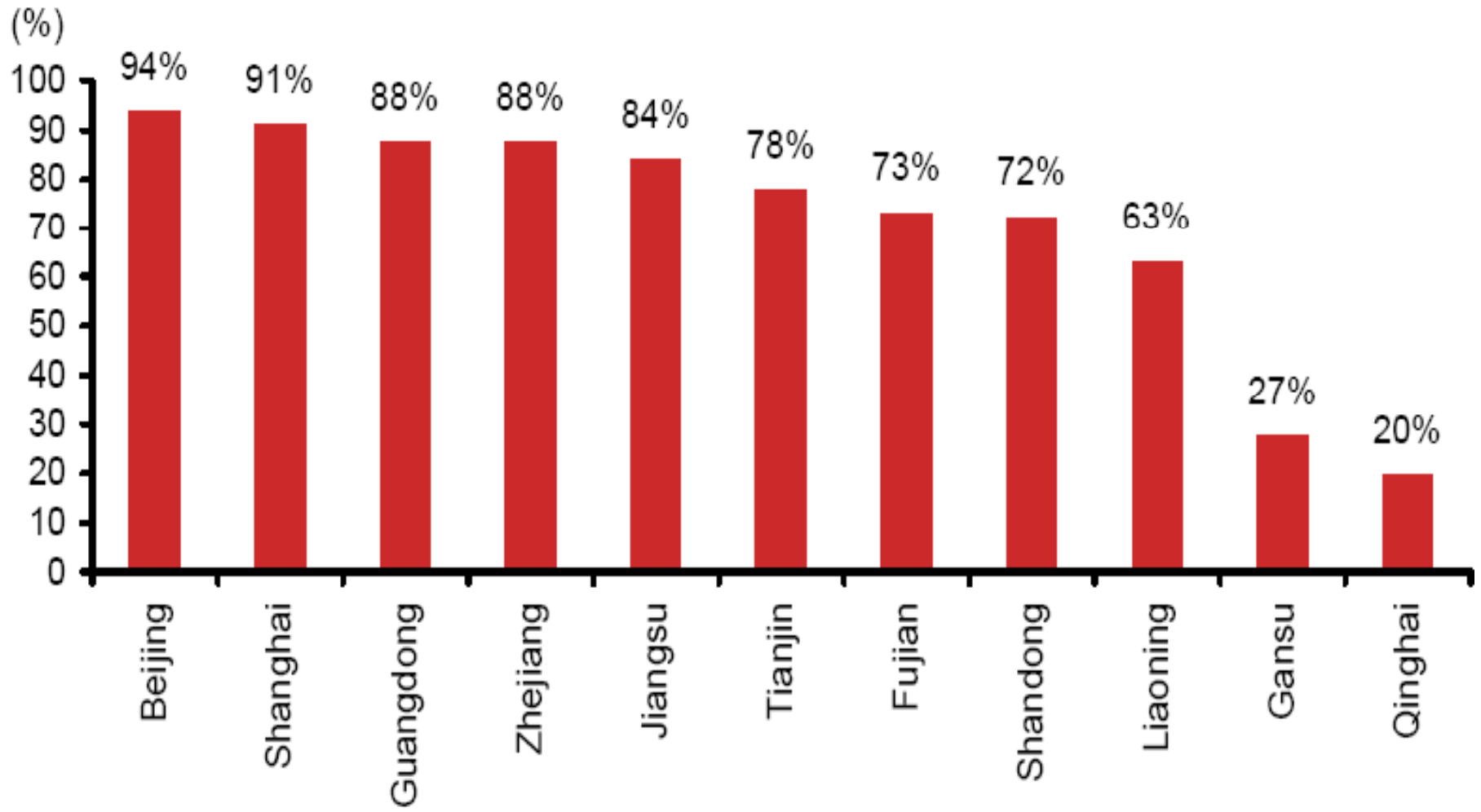


Source: CEIC, Credit Suisse estimates

Local governments are in deficit

Poor regions have higher deficits

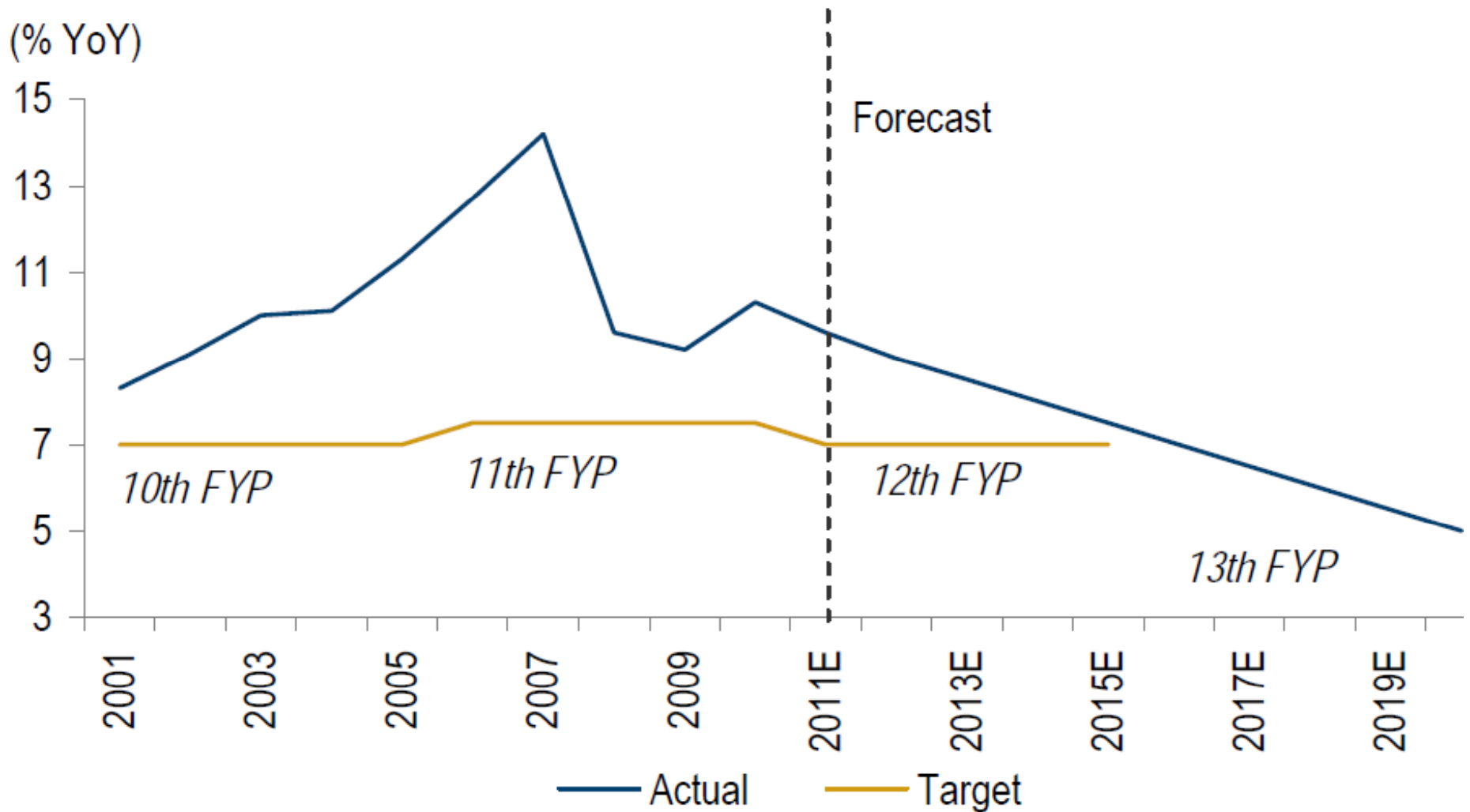
Local governments revenue over expenditure ratios, 2008



Is China's real GDP growth sustainable?

Optimistic forecast versus official targets

(Source: CEIC, Respective Five-Year Plan outline report, Daiwa)



How much progress can we expect from the 12th 5 Year Plan

- The same structural problems have been identified years ago and most of the 12th 5 Year Plan policies are the same as those in the 11th 5 Year Plan, but things worsened off since then
- Most of the structural problems are created by institutional problem and are interconnected
 - e.g. Low domestic demand is caused by other structural problems
 - Increase of taxation by all levels of government and increase of monopoly slow down growth rate of household income
 - All kinds of entry barriers set by all levels of government raise transaction costs and retailing prices
 - High income inequality makes majority households poor
 - Entry barriers and high transaction costs slow down growth of small and median enterprises and service sector (slow employment growth; Lack of varieties/options for consumers)
- Without addressing institutional problem, piecemeal policies may not make a progress
 - Would the the 12th 5 year plan a repetition of the 11th 5 Year Plan

The most challenging problems come from regional competition which has been essential for China's growth

- Regional competition and regional experiments in the past 30 years drive spectacular growth
- At the same time, most China's structural problems are also created by regional competition and regional experiments
 - Sub-national governments are responsible for implementing most policies (often with substantial de facto discretions); and are responsible for more than 90% of nationwide infrastructure investments
- Sub-national governments compete for investments at high social costs – a race to the bottom in many aspects such as:
 - Social costs due to local monopoly; land appropriation; crowd out private sector financial resources; entry barriers
- They experiment novel rent-seeking approaches, such as
 - Novel types of taxes, fees, entry barriers, entry barriers
 - Novel ways of appropriating land
- They are fairly robust to what they want to do when facing policies

The institutional foundation of regional competition

- Regional competition is created by China's institution: Regionally Decentralized Authoritarianism (RDA), which is featured by
 - Highly centralized personal controls
 - Nested personnel controls over all level subnational officials
 - Personal control as incentive instruments for the central government to lead
 - Highly decentralized economy
 - Subnational governments control most resources, e.g. most of the land, in China
 - China is fiscally most decentralized economy in the world
- The RDA creates conditions for regional competition
 - Officials' career paths are linked to the performance ranking
 - Regions are alike in structure of regional economies
- The regionally decentralized authoritarian (RDA) regime also relies on regional competition and regional experiments to solve incentive problems

Why regional competition is becoming a source of problems?

- Regional competition and experiment function well when the government's overwhelming goal is GDP
- When the government has multiple goals, such as those in the 12th 5 Year Plan, regional competition will have multi-equilibriums, including undesirable equilibriums
 - Tasks in conflict with GDP growth are often ignored
 - Subnational governments may race to the top/bottom for many tasks
- Multi-equilibriums in regional experiments: what to be experimented are determined by the nature of the race
 - May experiment novel ways of corruption
 - May experiment how to block judicial independence
- A basic dilemma in Chinese economy: regional competition is necessary to solve incentive problems of the RDA regime; however, sub-national governments' race to the bottom in the competition create structural problems

Non-market policies would not work

- There are many proposed/implemented policies that are not market oriented
- Redesign evaluation criteria
 - Adding new evaluation targets to control sub-national governments (e.g. Social stability, Public housing, Environment, etc.)
 - Eventually will fail due to the race-to-the-bottom problem
 - Design new comprehensive indicator to replace GDP (e.g. Green GDP)
 - Eventually will fail due to information/incentive problem
- Centralization: central government make direct decisions on local economic issues (info/incentive)
 - Even benevolent policies may end up with disasters (e.g. closing down smaller firms for protecting environment: destroy competition environment)

Market oriented policies may work

- One of the major concerned structural problems is R&D and upgrading technology in China's manufacturing sector
- Chinese government has lowered entry barriers of venture capitals and has supported venture capitals since the late 1990s
 - Become the 2nd largest venture capital recipient country in the world since 2003
 - Chinese VCs (many are SOEs) operate in the market and compete against their counter parts in the market
 - Most IPOs of high tech companies in the world (HKSE, NYSE, NASDAQ) in recent years are from mainland China, the best are backed by VCs from China and the US
- China may become the largest VC recipient country in the world very soon
 - Implications to the global R&D, global high tech markets and Chinese long run growth is profound
- How far China can go is determined by how China's institutional problems are solved

When will China become the largest economy?

It depends on how sustainable the Chinese growth is.

The nominal GDP if China's growth is somewhat sustainable

(Source: CEIC, Daiwa)

