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From the Desk of...

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China' sustainable economic growth; an outlook for the next fifteen years, written by Dr Yuwa Hedrick-Wong, Economic Advisor to MasterCard Worldwide.

November 2007: China's impressive economic growth for the past 30 years, averaging between 8% - 10% real growth per year, has been the envy of the developing world. The size of the Chinese economy by the end of 2006 reached US$2.62 trillion -- 13 times larger than in 1978, when measured in constant Yuan. This is higher than what Japan and the East Asian tigers had achieved during a similar period of economic take-off. China's GDP is now the forth largest in the world.

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There has been no shortage of sceptics about China's economic growth; as early as 1994 Economist Paul Krugman claimed to have exposed the myth" of Asia's economic miracle including that of China's dynamic growth. Concerns over the longer term sustainability of China's growth persisted. Recent scandals over the safety of China's products, as well as revelations of how badly damaged the natural environment is as a result of China's headlong push for economic growth, have merely added credence to the scepticism. And it is not just foreigners who have raised these questions. Most recently, even China's Premier Wen Jiabao expressed concern over the longer term viability of China's over-reliance on massive investment as an engine of economic growth.

The issue of long term sustainability of China's economic growth is important not only to China; but increasingly for global market too. This is simply because of China's rising economic weight in the global economy both as a supplier and a consumer. And China's financial clout is only just beginning to be appreciated (or feared as the case may be). However, one look at it, there is no escaping the conclusion that a balanced and dynamic China economy is good for all concerned over the long term.

Results confirm on the other hand that the input driven growth has been very important for China's growth up to now. In this regard, critics who lambasted China for relying on the sheer weight of capital and labour to drive economic growth are partially correct. On the other hand, the results suggest that large gains in efficiency, i.e. total factor productivity (TFP) were behind China's economic growth. This is not surprising because TFP is typically associated with functions of the market economy in which business competition and entrepreneurial drive and accurate price signals make continuous efficiency gains possible.

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So what factors are behind TFP growth?

Much comes down to urbanisation, infrastructure, foreign trade and transfer of management know-how. One factor that subtracts from TFP growth, however, is government administrative cost, a proxy for estimating government's direct role in the economy, i.e. owning and operating businesses -- the more the government is involved, the more the government reduces TFP growth.

Evidence of strong TFP growth could explain one of the puzzling phenomena of China's recent economic development; the extraordinary high levels of profit earned by Chinese firms. Since 1998, wages have increased by about 14% p.a. while export prices have fallen and while prices of imported commodities have risen in real terms. Usually a combination of these factors would mean a serious case of profit squeeze. Output per worker during the same period, however, has increased by 20% p.a. thanks in no small measure to TFP growth. Hence Chinese firms have continued to enjoy rising profit margins in spite of higher costs. The difference in forecasts of economic growth over the next 15 years is limited to a narrow band ranging 2-4 % p.a., i.e. we are looking at between 6-8% and 9-10% p.a. Virtually all the difference comes from projections of TFP growth, due mainly to different assumptions regarding government administrative cost and the consumption-to-GDP ratio. In the 'basic scenario', TFP growth is projected to decline very quickly, whereas it is sustained at the 3% + level per year in the 'alternate scenario'. The conclusion is therefore clear; China's high rate of economic growth is likely to be more sustainable if TFP can be kept at the present level of about 3%. This will in turn requires a reduction in government administrative cost and a rise in the consumption-to-GDP ratio.

The 15 year outlook for China; 6-8% or 9-10% if TFP can be kept at 3% p.a.

Reform measures required to sustain TFP

Curbing excessive investment: High rates of household savings are often cited as the culprit for China's high level of investment and all its associated problems. But the reality is that in recent years, China's household sectors' savings rate has actually *declined* from 53% of total national savings in the early 1990s to about 40% in 2005. Government saving has increased slightly due to tax revenues increasing faster than expenditure increases (this in spite of the government's increased spending on health, education, social welfare and transfer payments in rural areas). The single biggest source of increased national savings has been the rise in corporate savings from 28% of the total in the mid-1990s to more than 40% in 2005, due largely to their healthy and improving profit margins.

State-Owned Enterprises (SOEs) do not pay dividends, generally still have highly preferential access to bank lending and those in the resource industries do not pay royalties for their rights of exploration and SOEs. Curbing excess investment in China may therefore require restructuring the governance of China's SOEs. Total trade now accounts for about 70% of China's GDP and its massive trade surplus shows no sign of slowing. Excess investment is a key factor in China's growing export dependence but is increasingly dependent on global demand. To compete successfully and keep gaining global market shares China's exporters have been raising the capital and technology intensity of production to move quickly up the value-added ladder. All this is in spite of China's still huge labor supply and prevalent underemployment in rural areas. This in turn has created an industrial structure that is increasingly out of alignment with China's comparative advantages. Many export subsidies have already been reduced or eliminated all together.

Curbing local governments' investment: Many environmental disasters, abuses in land acquisition and outright pilfering of the public purse are related to local governments' involvement in businesses. This is also correlated with excess investment. Reform measures in moving local governments out of business will go a long way in raising TFP growth.

Continuing financial sector reform: Financial sector reform (the banking sector in particular) has been making steady progress over the past ten years and a core problem, non-performing loans (NPLs) has been largely brought under control and the much heralded banking crisis appears to have been avoided. Future reforms in opening up the domestic retail market for new investment vehicles (by both domestic and foreign financial institutions) and improving access by private entrepreneurs to financing will be particularly effective in driving TFP growth.

Maturing entrepreneurship: China's entrepreneurs got started only 10-15 years ago so they are still very much a "first generation" phenomenon. While they exhibit tremendous drive and optimism, they are also less sophisticated (as often seen in comparison with Indian entrepreneurs, for instance) and these first generation entrepreneurs will likely come of age over the next 15 years, becoming more seasoned business operators.

Rising research & development investment: R&D is a key factor in TFP growth. Starting from a very low base, expenditure in China has been growing relatively fast in recent years, reaching 1.4% GDP in 2006. As more Chinese companies become more "innovation-driven" and start to focus on building their own brands, the domestic lobby for intellectual property protection will become stronger and more influential.

Urbanisation: This is one of the most important factors in driving TFP -- somewhere between 15-20 million people are urbanised each year, a historically unprecedented phenomenon, and by 2020, China's urban population will likely reach 60% of the total.

Reform of State-Owned Enterprises: SOE reform has been a qualified success to date, however, privatisation has been most effective in the small and medium SOE sector.

Risks that could threaten future growth in China

Corruption: In spite of many government-led anti-corruption drives, it is still an endemic problem in China. Up to now, corruption has not derailed economic growth but in the coming decade it is conceivable that a worsening of corruption could aggravate social instability, worsen environmental deterioration and start to become a serious drag on economic growth.

Asset bubbles: Currently the risk still appears relatively small. The total value of tradable shares, for instance, is only some 35% of GDP, much lower than the 180% peak recorded in the US in 2000. Equities also account for less than 20% of total household assets, compared with 50% in the US. While there has been double digit increases in property prices in some neighborhoods of large cities like Shanghai and Beijing recently, the ratio of house prices to average income has actually fallen by about 25% since 1999. So while the risk of asset bubbles should not be ignored, nor should it be over-exaggerated.

Resource constraints: Inefficient resource utilisation has aggravated resource shortages. China's fresh water endowment on a per capita basis has been very low to begin with, and a lack of effective enforcement in environmental protection, coupled with corruption at the local government level, has greatly worsened the deterioration of water resources in China.

Ecological deterioration: Degradation beyond a certain threshold could render economic growth impossible. Curbing the deterioration of air and water quality in large urban centres is critical to create a healthy urban environment for hundreds of millions of urban dwellers and the proper functioning of China's urban economy.

Health and safety standards: Recent scandals of China's export products being recalled on a massive scale overseas underscore the challenge of ensuring health and safety standards in China. the central government simply lacks the necessary capacity for enforcing standard; especially when many Chinese producers operate in the "informal" sector. This is further aggravated by local government corruption, particularly when there is local government/business collusion. Chinese companies, on the other hand, have so far not been concerned with brand-building in growing their business -- they are quite content to sell as much as possible under a no-name arrangement without any brand asset to protect. Chinese companies are not under the same pressure to comply with health and safety standards. The massive supply chains involved in most production in China means that it is simply very difficult to track who is supplying what to whom -- it takes one single upstream supplier to 'contaminate' an entire supply chain.

Concluding Observations

This analysis shows that the sustainability of high economic growth (9-10% p.a.) in China in the next 15 years will have to rely mostly on TFP growth. China today faces a turning point in managing economic growth. The good news is that China has already established a solid basis of achieving growth through efficiency gains, witnessed by the significant level of TFP growth in the past decades. The future challenge now is to ensure that this process continues. Successful implementation of a range of reform measures will be critical to achieving such TFP growth, including reduced corruption, reversing the trends of environmental deterioration, trimming of trade surplus, raising the consumption to GDP ratio, and stronger support for entrepreneurs.

Acknowledgement

This article was edited from a report by Dr Yuwa Hedrick-Wong for MasterCard Worldwide. To read the full report complete with graphs and additional statistics please download this from a link on the author's web page

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