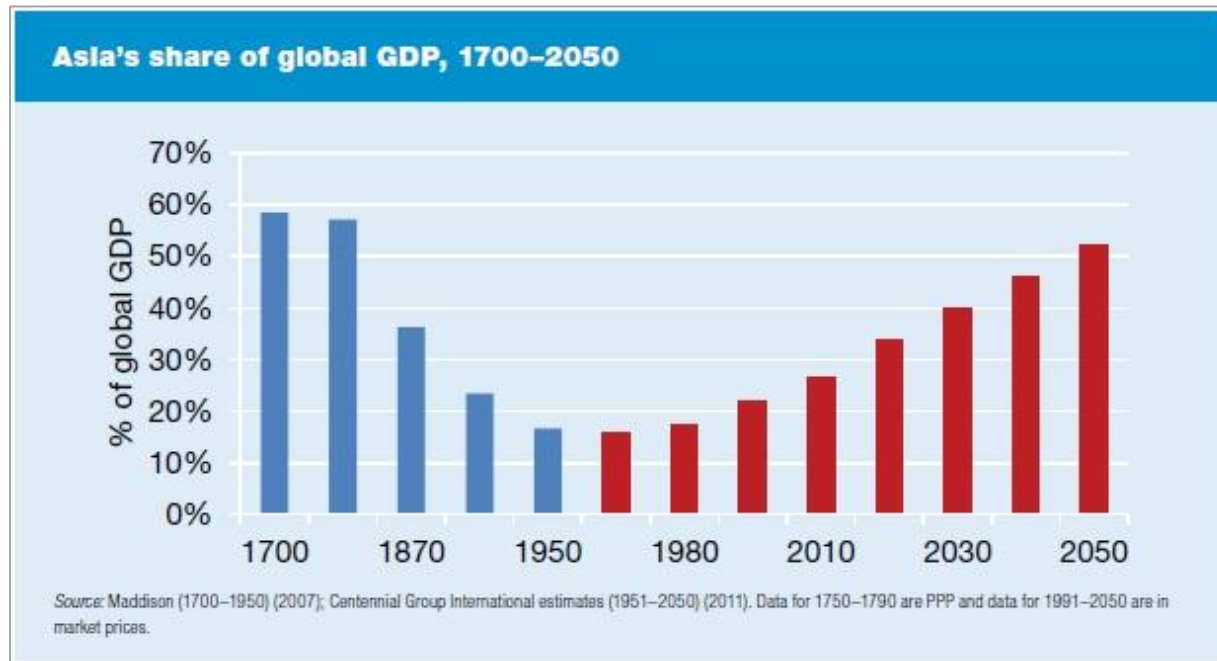


China's Economic Growth Model

Medium and Long Term Challenges

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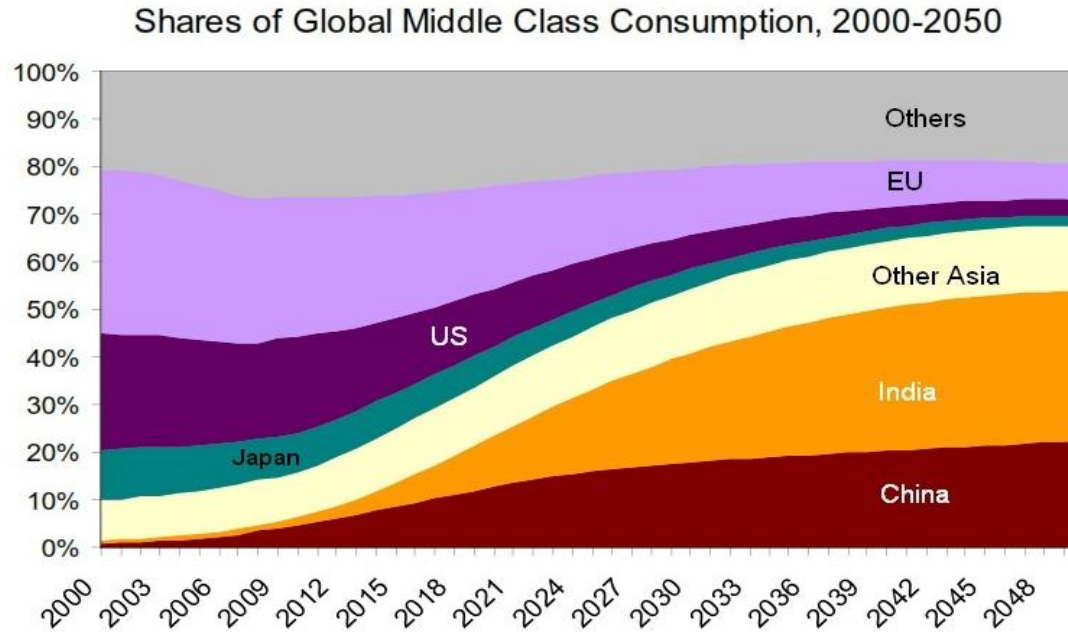
Centre of economic gravity is shifting back to East



Asian Century Scenario by Asian Development Bank

- **Asia's share of global GDP to double to 52%** (US\$174 trillion at market exchange rates) in 2050
- With a per capita GDP of US\$40,800 (PPP), Asia would by then have incomes similar to today's Europe
- Asia would have roughly half of total global financial assets

Asia will account for more than 60% of global consumption by 2050, but we may need more than one earth if we copy American lifestyle

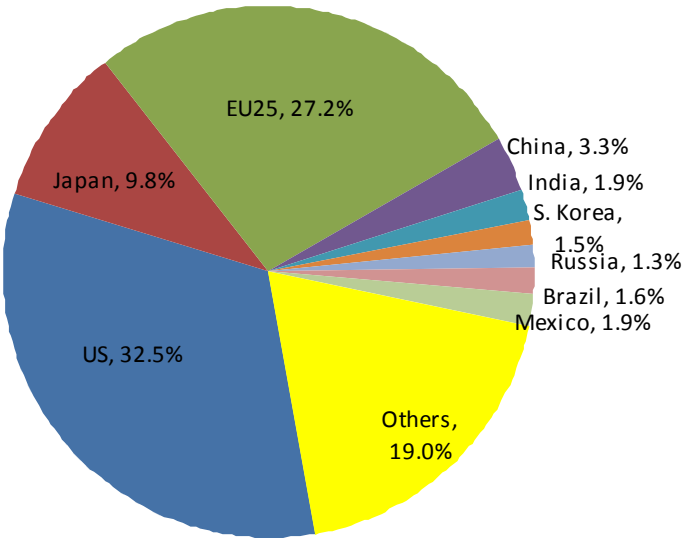


Numbers (millions) and Share (percent) of the Global Middle Class

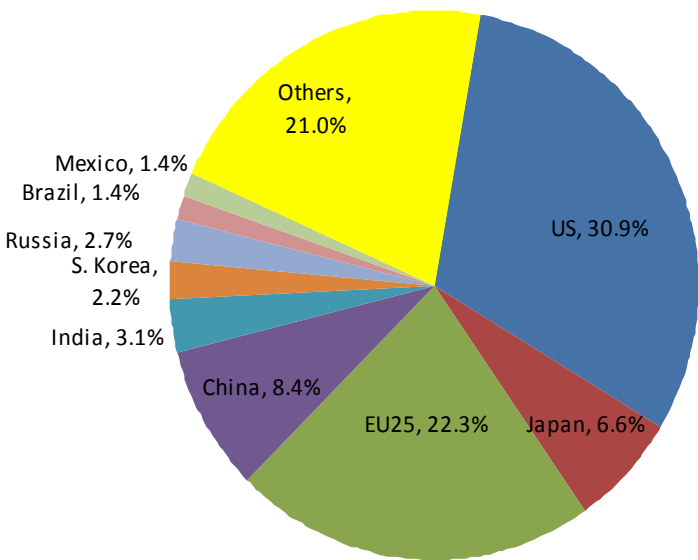
	2009		2020		2030	
North America	338	18%	333	10%	322	7%
Europe	664	36%	703	22%	680	14%
Central and South America	181	10%	251	8%	313	6%
Asia Pacific	525	28%	1740	54%	3228	66%
Sub-Saharan Africa	32	2%	57	2%	107	2%
Middle East and North Africa	105	6%	165	5%	234	5%
World	1845	100%	3249	100%	4884	100%

Purchasing power is shifting from West to East, but global finance is still dominated by the West.

Share in world consumer spending in 2005



Share in world consumer spending in 2020



Rising purchasing power in emerging economies will drive changes in the global supply chains but global financial crisis may disrupt the process

Three major trends are emerging and they will become the key drivers for transformation in China and other emerging markets

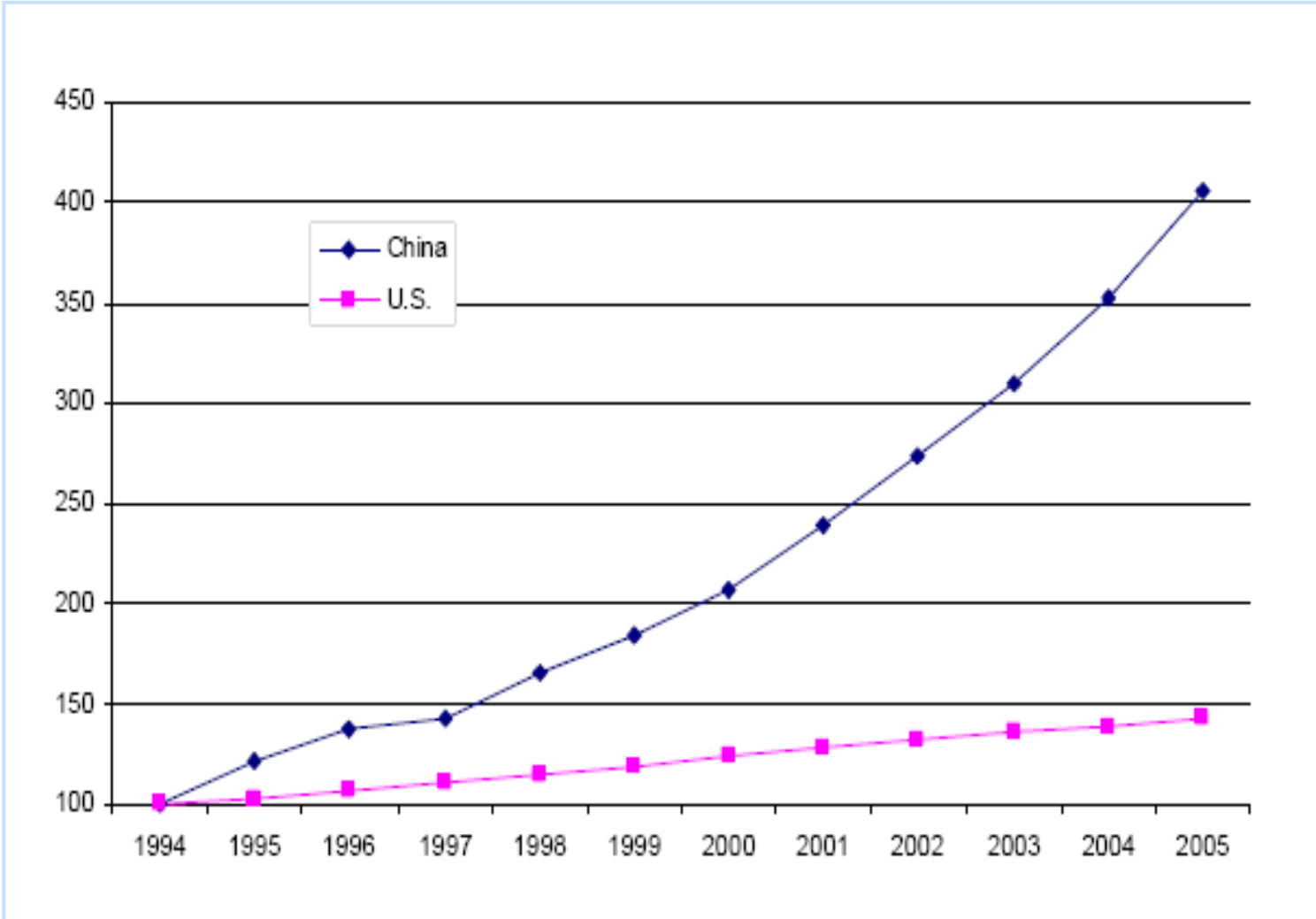
- (1) Rising costs of labor and rent:
 - Productivity growth and rising wages and non-tradable (such as property)
- (2) Rising costs of real capital:
 - Higher return on capital and rising prices for capital (real interest rate) due to rapid industrialization and urbanization.
- (3) Rising costs of resources:
 - Rising costs of carbon emission and natural resources due to limited supply of clean energy and raw materials.

(1) Rising costs of labor and rent:

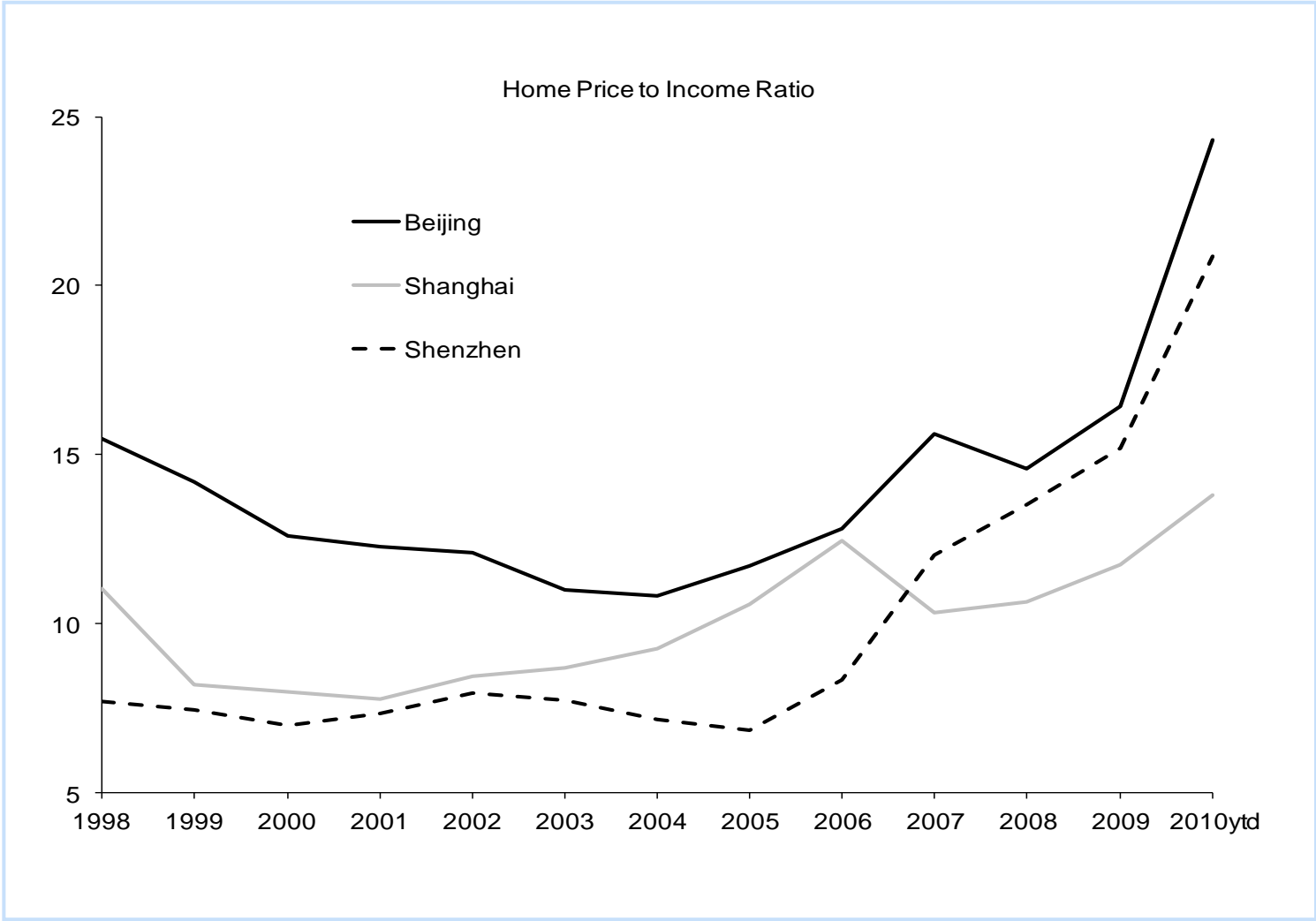
Rising Wages and Non-tradable (property) value in the emerging market for next few decades

- The wages and non-tradable prices (such as property price) in the emerging markets will go up rapidly, generating healthy domestic structural inflation in the emerging markets
- This trend contrasts sharply with the deflationary pressures in the advanced economies due to the balance sheet adjustment after the recent global financial crisis.
- Key policy implications: Rising costs of labor and rents will sift production networks (supply chains) to lower costs regions

Nominal Wage in China and the US.

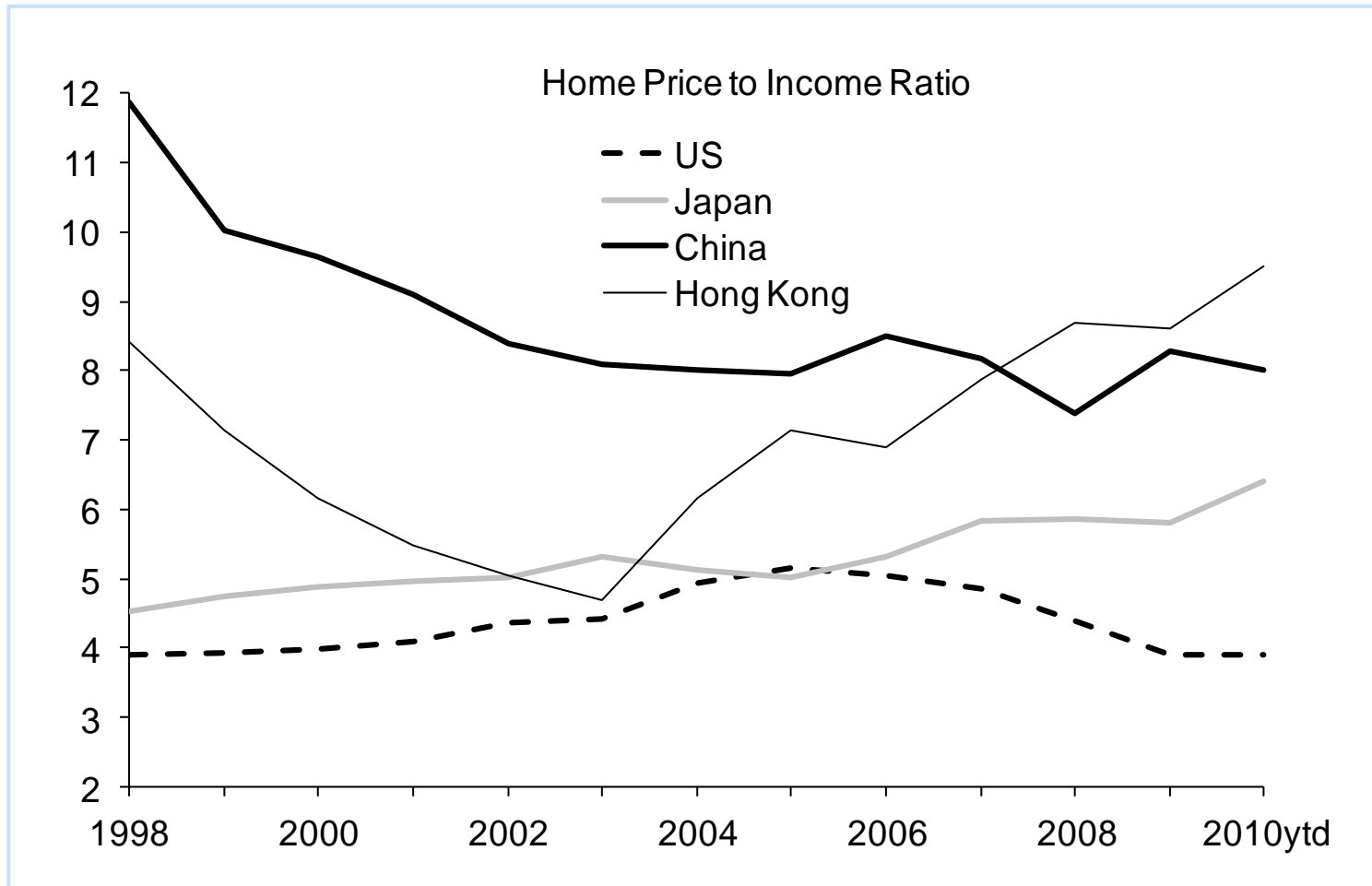


Property prices in a few large Chinese cities



Note: The property price series of Shanghai could have a downward bias due to large inclusion of suburban housing.

Home prices in China on average have become more affordable since 1998 when the privatization of housing started

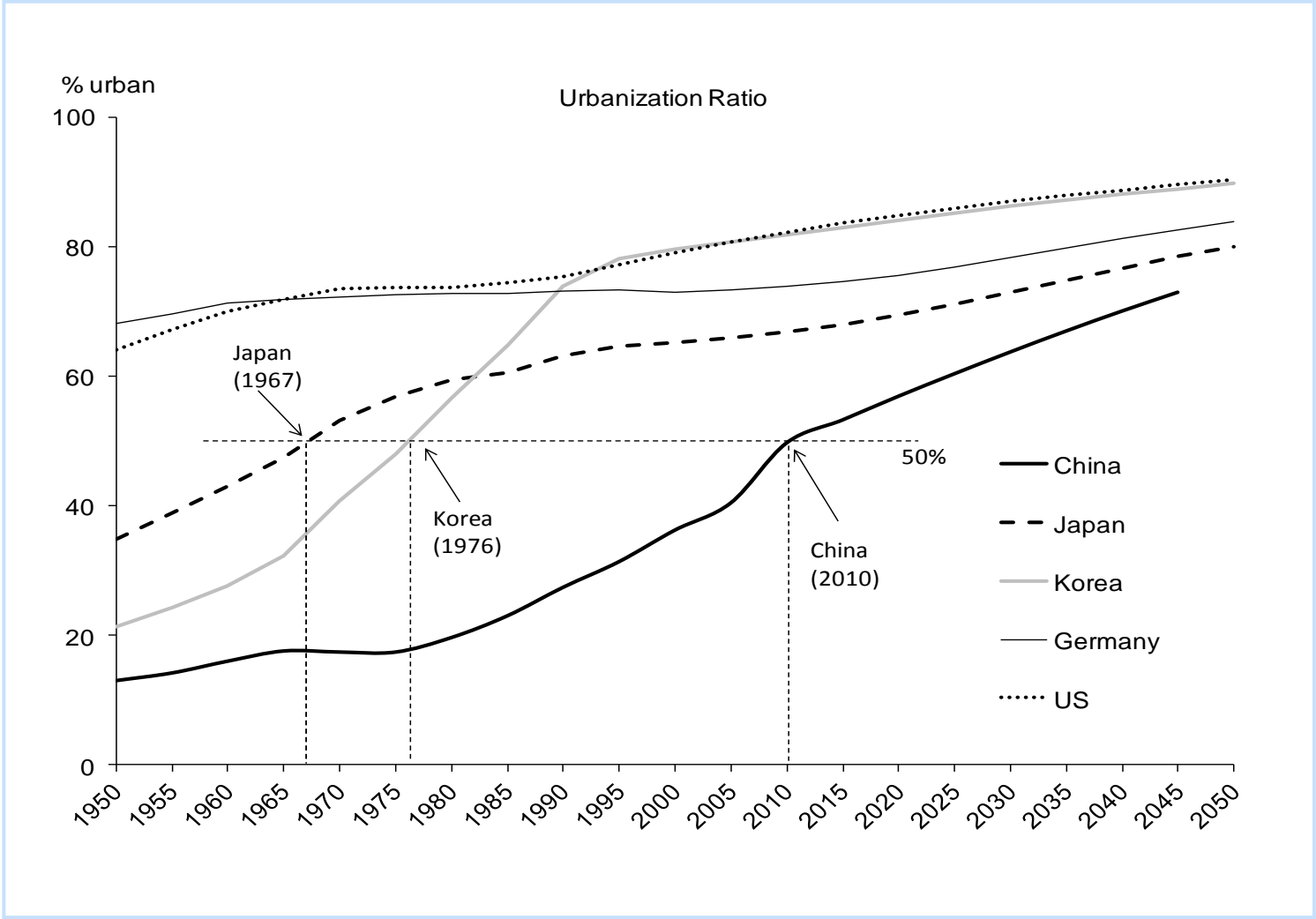


(2) Rising costs of real capital:

Rising price of real capital (real interest rate) in emerging markets in the next few decades

- The rising demand for infrastructure work required for industrialization and urbanization will lead not only to structural inflation but also increasing scarcity of real capital in the developing economies (or higher real interest rate)
- This contrasts sharply with deflation and zero interest rate environment in advanced economies like US, Japan, and EU.
- Key policy implications:
 - Nominal interest rate should be higher than structural inflation rate.
 - Emerging markets should have higher inflation and interest rate than advanced economies.

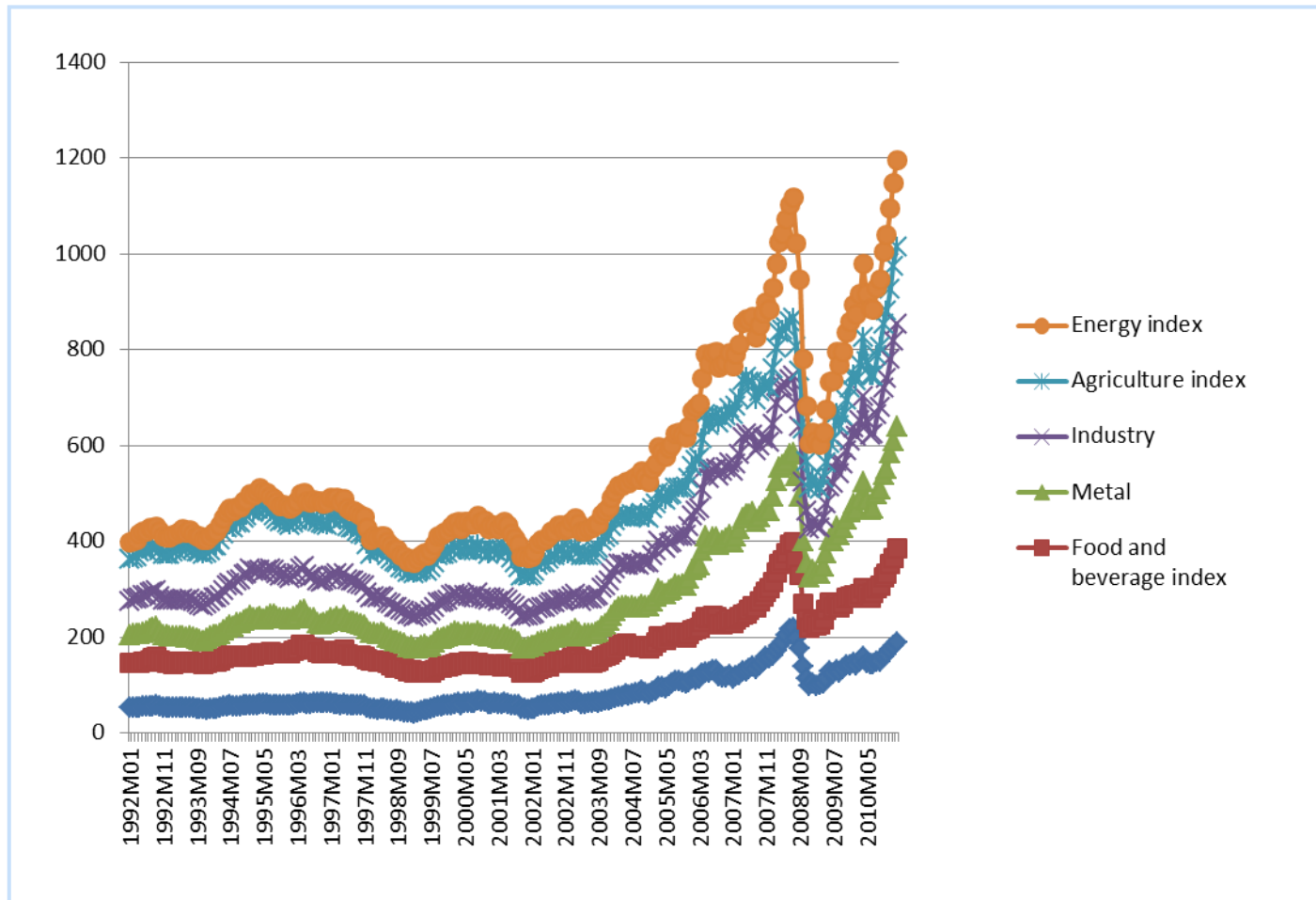
China still has a long way to go in urbanization



(3) Rising costs of resources:

- The rising demand for natural resources and the increasing recognition on the harmful effects of carbon emission means that their prices will rise.
- This contrasts sharply with the waste and low efficiency in the use of energy and natural resources in many developing and even some developed countries.
- Key policy implications: prices for natural resources and carbon emission needs to be raised but their volatility needs to be managed.

Price index for energy and commodities



What are the key challenges for the global transformation?

- Global coordination capacity is well behind the demand on it because:
 - Policies are made primarily by nation states for short-term objectives but their impacts are easily felt globally and in the longer term;
 - Gains and losses in the current global structural changes are distributed unevenly and cause serious trade protectionism and block good economic policies from being implemented in many countries.
- We need to emphasize the world-wide, systemic and holistic research to tackle key challenges in the real world to ensure the long-term sustainable transformation

Three Pillars of China's Growth Strategy

- The Party
- The open door policy
- The market-oriented reform

- The later two are consistent with standard economic theory, while the first is a unique element of China Model

What is special about the Party in China?

- Although other Easter Asian countries have similar enlightened dictatorship, the leadership by the Party distinguishes China's development model from others.
- The Chinese Communist Party was born and grew out of crisis and war and gained its authority as the only leadership force for a population as large as 1.3 billion through internal competition and external pressure.
- Over a period of more than half a century, the party developed a sophisticated and resilient central and local organizational capacity for defining and enforcing its policies (right or wrong), including defining and protecting property rights during the reform period
- The Party has become an imperfect but working substitute for many key modern institutions China lacks during its long process of modernization (institutions such as markets and free trade, social safety net, independent judiciary and rule of law, free press, and democracy)

Property Rights Infrastructure (PRI) is the crucial link between the State and the Market (which are the two sides of the same coin)

- PRI comprises three broad categories of institutions/ processes for:
 - Delineation of property rights
 - Exchange of property rights
 - Protection, enforcement, adjudication, and fine-tuning of property rights
- The quality of the State determines the quality of the property rights infrastructure.
- The quality of property rights infrastructure determines the quality of the market, which is the platform for trade or the exchange of property rights.

Property Rights Infrastructure as an economic growth highway

- Importance of Property Rights Infrastructure in a Growth Model which includes the following:
 - the driver (the individual)
 - the vehicle (the enterprise)
 - the traffic rules (policies and regulations)
 - the traffic police (regulators)
 - the quality of the highway (property rights infrastructure)
 - the brightness of street lamps (transparency)

Misunderstandings about China's macroeconomics

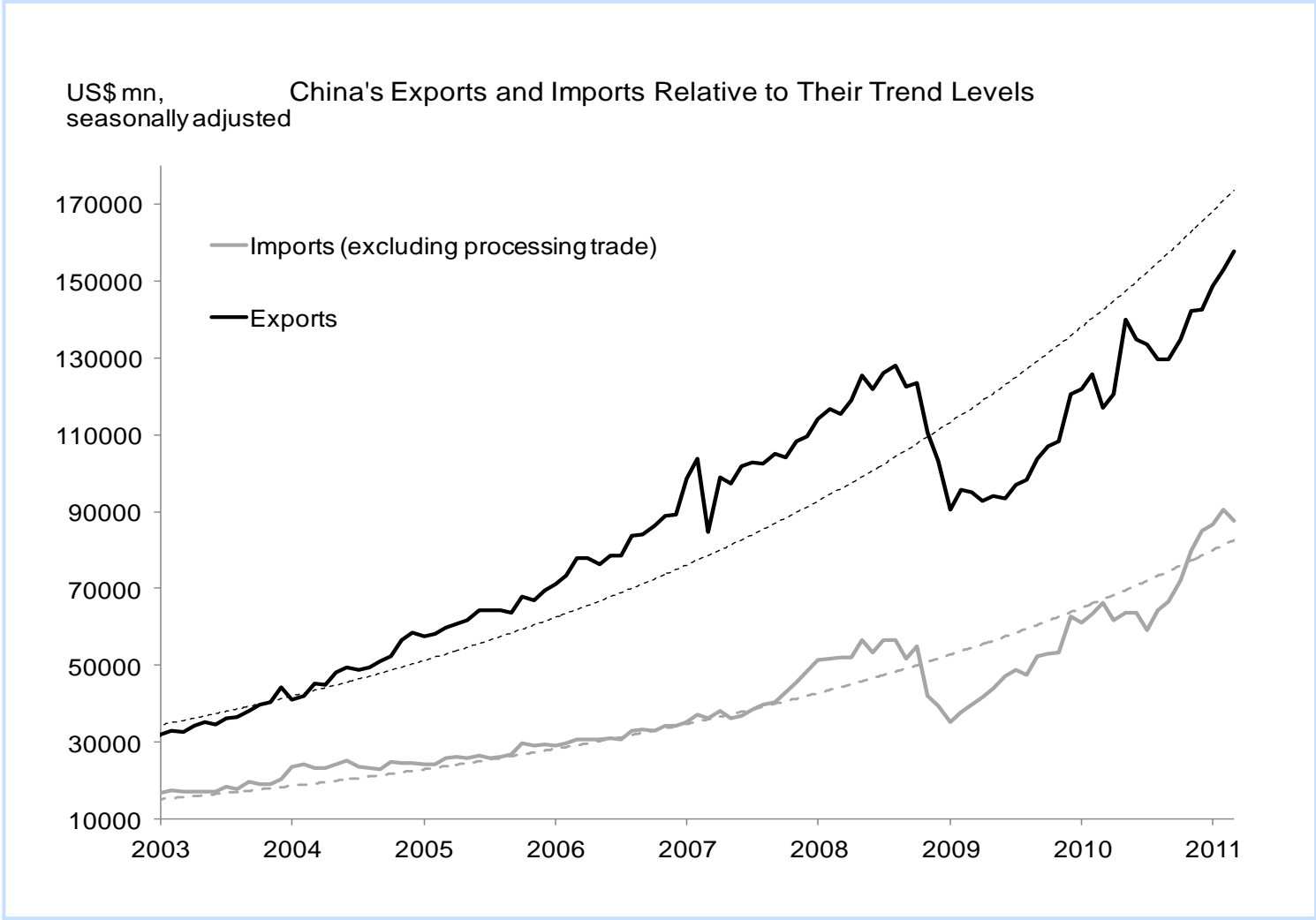
- China's competitiveness
 - is more about declining transaction costs due to reform, rapid technological progress due to opening and globalization, and low labor costs due to large surplus rural labor than exchange rate adjustment and current account imbalance
- Current account surplus
 - is more about exporting of surplus capital which cannot hire surplus labor productively, than about competitiveness.
- RMB appreciation/depreciation
 - is more about China's inflation/deflation rather than about China's competitiveness; Inflation and RMB appreciation are substitutes in the longer run and they are equivalent channels for the adjustment of China's domestic price level relative to that of US (real appreciation of RMB)
- Bubbles in property and stock markets
 - is more about low or negative real interest rates and inefficient investment than about exchange rate, current account surplus, inflation or competitiveness

Why has China become so competitive over the last thirty years?

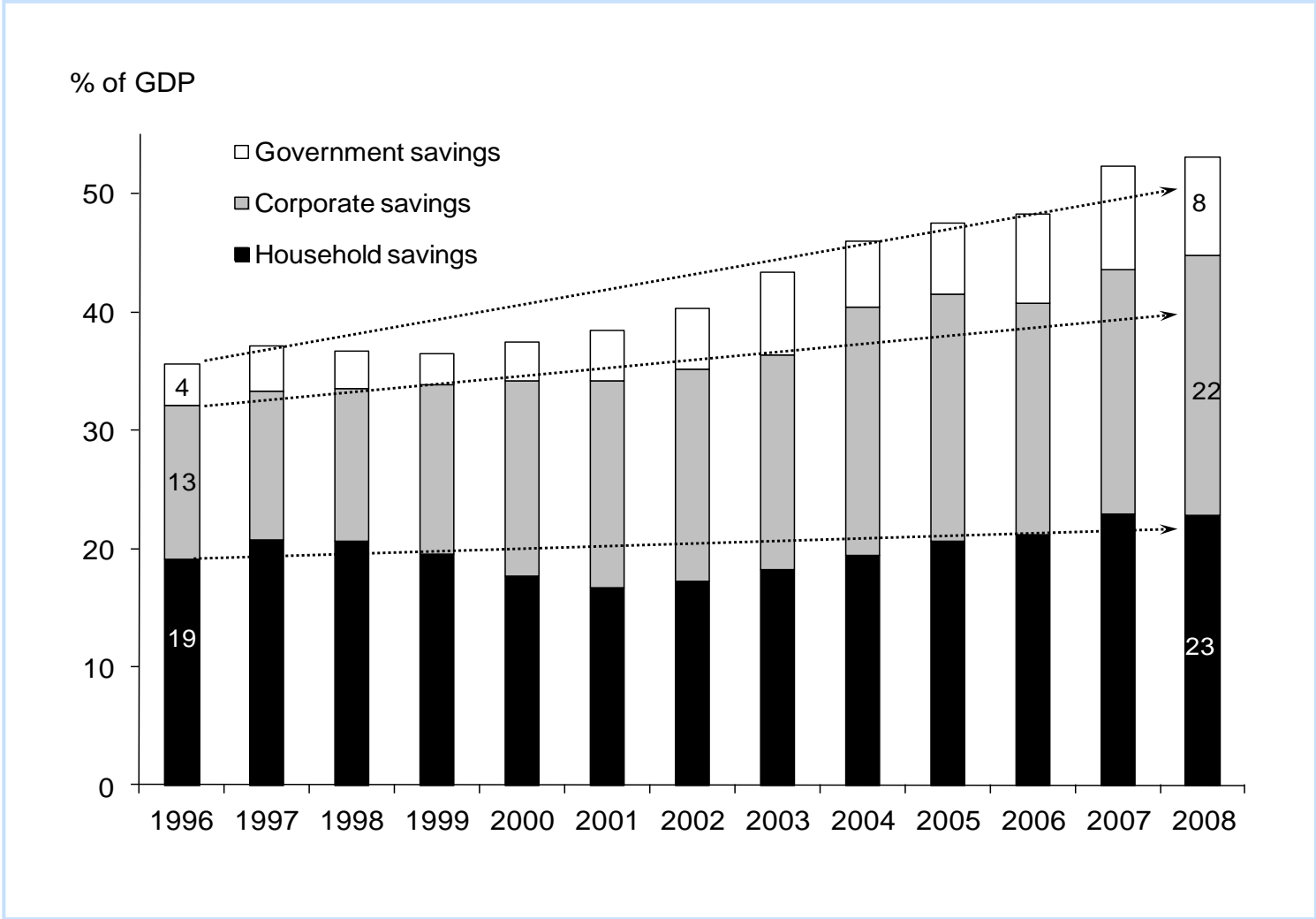
Declining Transaction Costs!

- Transaction costs
 - Costs of inadequate institutions and incentives
 - Any human-made costs that hinders mutually beneficial trade
- $\text{Competitiveness} = 1 / (\text{Transaction Costs} + \text{Factor Costs})$
- → China is becoming more competitive because of reforms that bring the benefits of both the state and markets!

China's trade has been growing rapidly but its trade surplus becomes a target of international trade protectionism



China's High Saving (closely related to trade surplus) is mainly from the Government and SOEs



A More Useful Framework for Analyzing China's Inflation Rate and Exchange Rate Change

China's Structural or/and Monetary Inflation

+ RMB appreciation against USD

=

US Inflation

+ Speed of convergence in price levels (or per capita GDP)
between the US and China

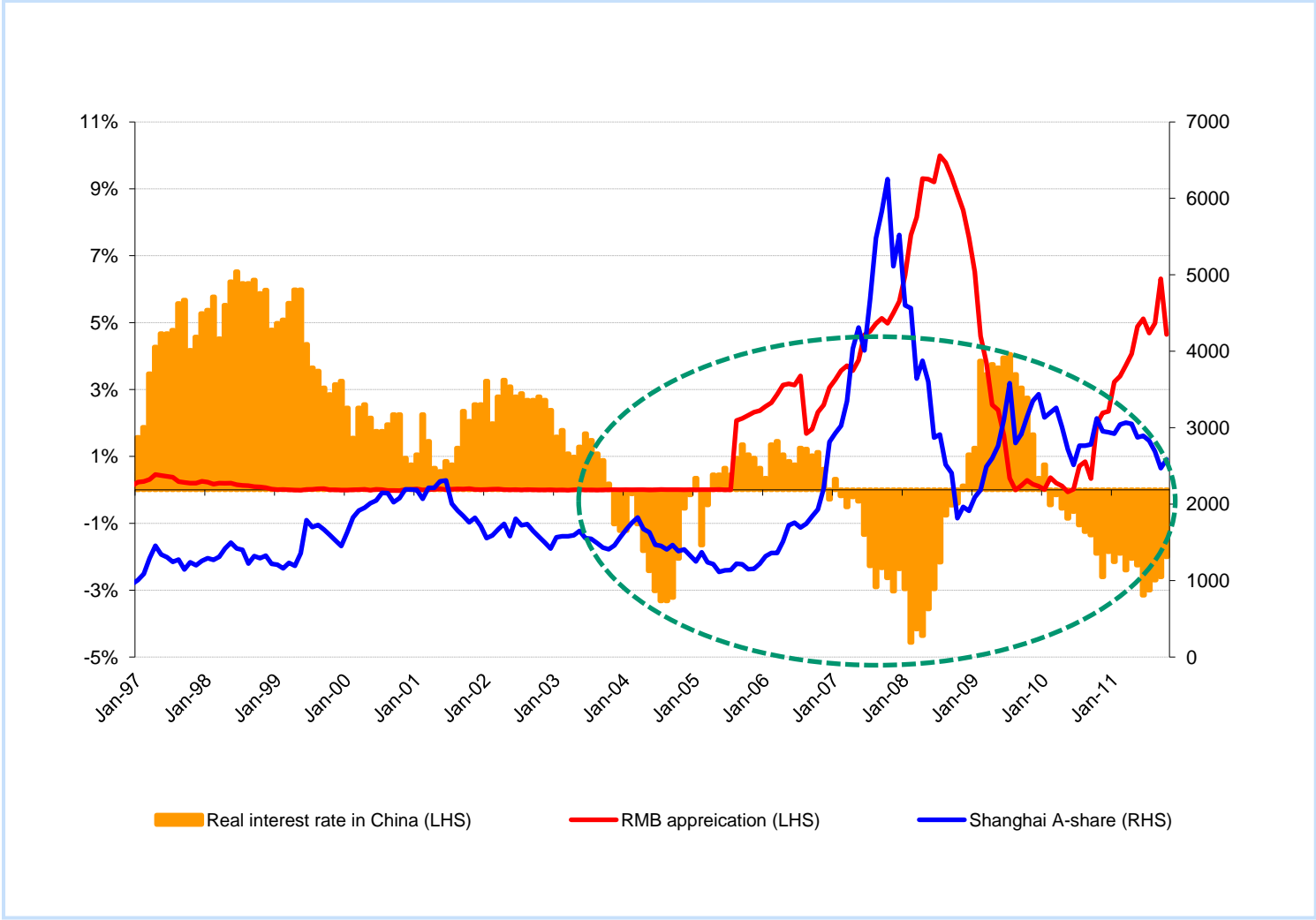
China is Unconsciously Subsidizing the Consumers around the World!

- Price controls on energy and raw materials
 - Which distort prices for major factor inputs
 - Leading to over-use of energy and raw materials and environmental damages
- Unclear ownership or state ownership of natural resources
 - Which distorts prices for many natural resources
 - Leads to over-use of natural resources and environmental damages
- Large SOEs in the monopoly sectors
 - Distort prices of their products and services
 - Leading to over-use (i.e. electricity) or under-use (i.e. telecom services) of their products and services
- China is effectively subsidizing consumers of Made-in-China products around the world, which is not sustainable!

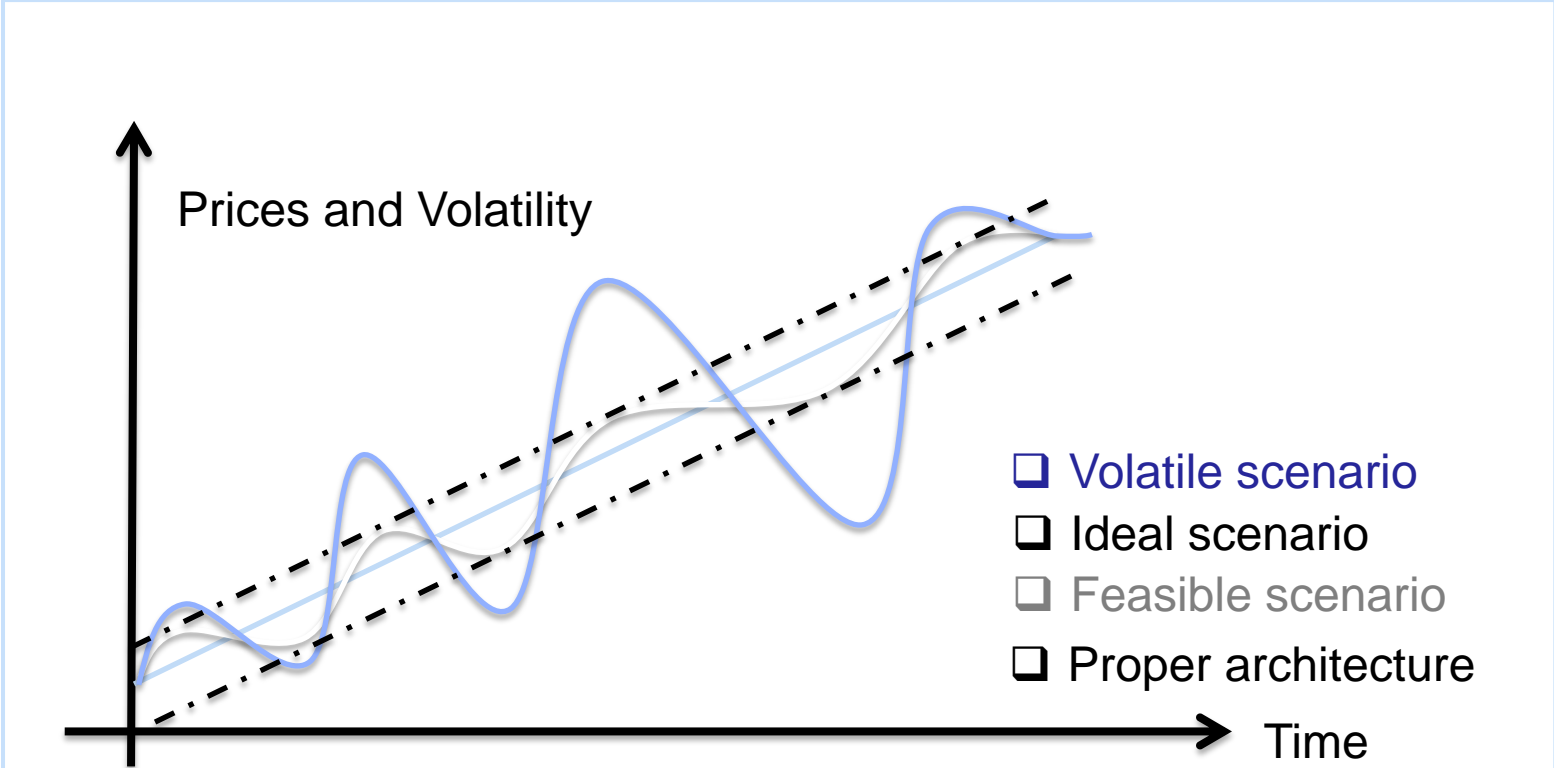
China's Macro Dilemma

- Because of the difficulties in distinguishing productive investment from unproductive investment, the central bank of China faces a dilemma:
 - If it adopts a loose monetary policy, it will have to deal with over-capacity when unproductive investment expands out of control
 - If adopts a tighter monetary policy, it will have to deal with a current account surplus when imports and productive investment cannot grow fast enough to keep up with the expansion of exports
- The key is to increase real interest rate (the price of capital)!
- Why not? SOEs, local governments, property owners, ... all against raising interest rate at the expense of poor depositors!

China's macro volatility: low real interest rate and RMB appreciation



Managing volatility to maintain a sustainable upward trend in wage, income, wealth, purchasing power, price of resources and pollution

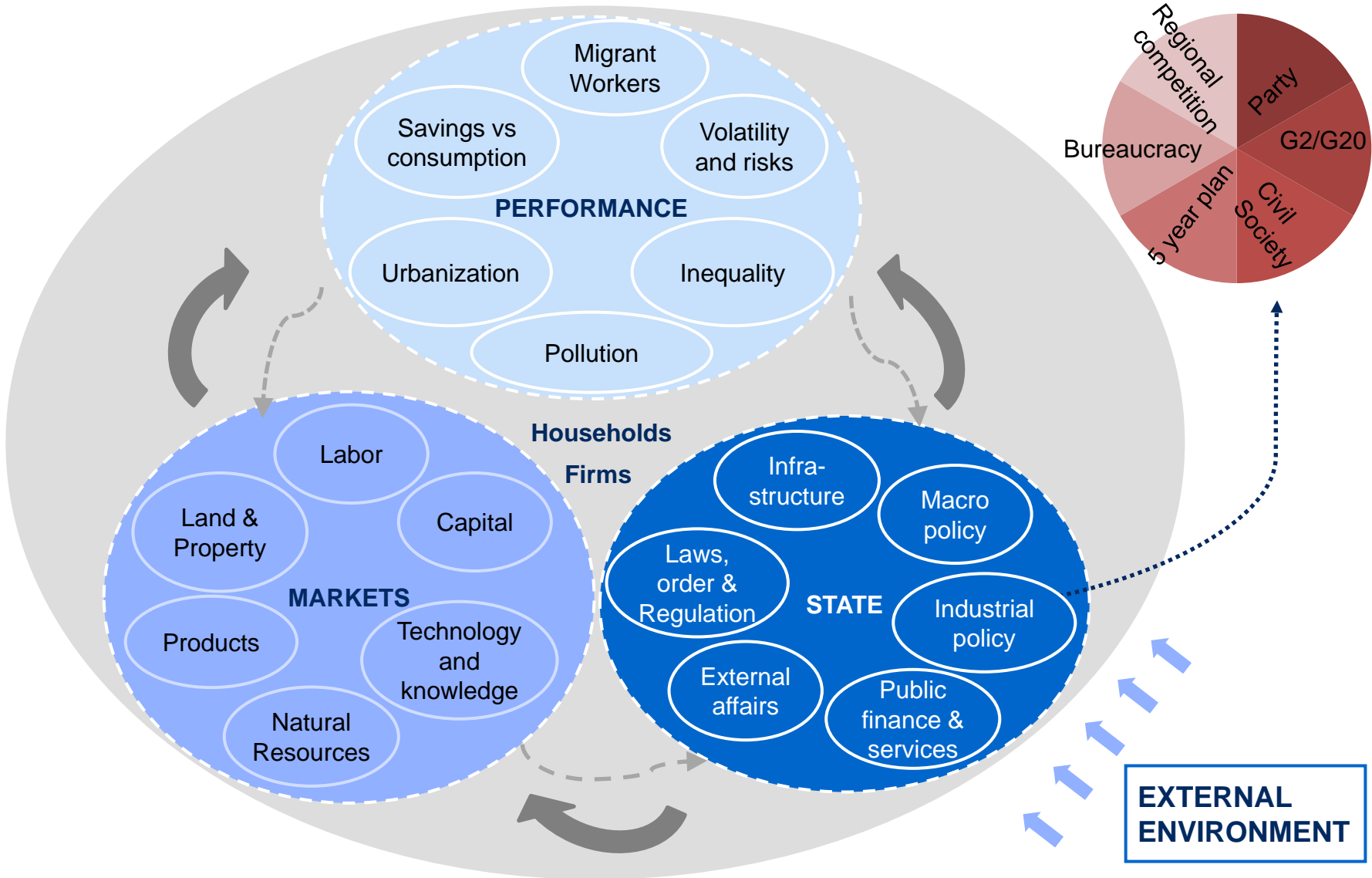


As China's income and price levels are converging with those of advanced economies, it needs a proper economic and financial architecture that can minimize disruptive boom and bust

Four Research Projects at Fung Global Institute

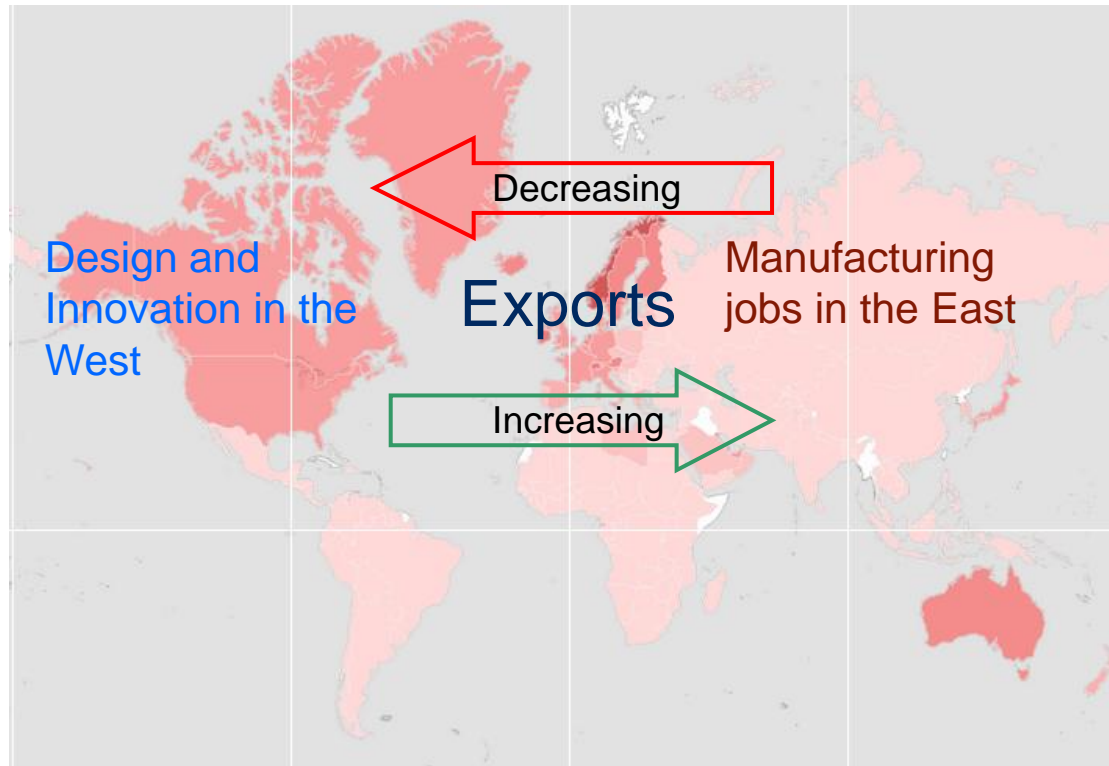
Dimension	Project	Background	Main Question
Real Sector	Global Supply Chains: A Shifting Landscape for Trade, Jobs and Value Creation	Business and policy imperatives are driving the Supply Chain shifts at both micro and macro-economic levels	How will the next generation of the global supply chains shift trade, jobs, incomes, profits and wealth in the context of rapidly changing global landscapes?
Finance	Asia Finance 2020: Towards a New Architecture for People and Business	Asia's real sector development, driven by trade and investment, hinges on the efficiency, stability and robustness of its financial systems	What type of financial system should Asia have that can foster sustainable and equitable growth, avoid systemic risk and serve the real economy better?
Sustainability	Asia's Role in Shaping the Global Future of Sustainability	Asia as the world's growth driver is well-positioned to experiment with a new sustainable growth model that is not based on material expansion and consumption	How will Asia create new lifestyles that will be consistent with its dense population, local and global resource constraints, and diverse backgrounds as its urbanisation and industrialisation deepen?
Governance	China and India: Searching for Asia's New Growth Models	China and India's respective five-year plans provide comprehensive blueprints on transformation opportunities and risks for global business community	How will China and India balance the role of the state and market in their search for new growth models to deal with their internal structural distortions, external risks and resources constraints?

A holistic view of an economy



1 Elements within each cluster are non-exhaustive

Global rebalancing is happening, will continue, and will shift jobs and value across borders



- Until recently, the West captured the design and innovation work while outsourcing cheaper jobs to the East
- Shifting geo-economic weight is creating profound economic, political and social implications not fully understood
- Global supply chains are becoming bi-directional as Asia's purchasing power increases with its higher growth rate

Thank You!