

The Chinese Economy over the Next Five Years

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A Preview

- ◆ The Chinese Economy Today
- ◆ Principal Points
 - ◆ The “World’s Factory” (surplus labor) but also the “World’s Market”
 - ◆ Domestic demand-driven growth financed with domestic savings and largely immune from external shocks
 - ◆ Renminbi is strong; non-performing loans problem not critical; unfunded pension liabilities to be funded with state-owned assets
- ◆ The New Team—technocratic, reform-minded, image-conscious, grass-roots oriented and concerned with maintaining social stability (Will it tackle corruption?)
- ◆ Opening up the Party—the “Three Represents” —(rewards and risks)
- ◆ The Economic Development and Reform Agenda—Building a Moderately Well-Off (Xiaokang) Society by 2020
- ◆ The Impact of SARS
 - ◆ Relatively small economic impact limited mostly to 2003Q2
 - ◆ The importance of accurate and timely information—multiple independent channels (a freer press?)
 - ◆ Multiple-sourcing by customers (diversification or supplies both within China and between China and the rest of the world)
- ◆ Taiwan is the only issue on which there is little flexibility for any movement—however, the status quo can be maintained.

The Chinese Economy Today (1)

- ◆ East Asia is the fastest-growing region in the world over the past two decades, the East Asian currency crisis of 1997-98 notwithstanding.
- ◆ China is the fastest growing country in East Asia—approximately 9% p.a. since beginning of economic reform (1979) and 7.7% over the past five years.
- ◆ Between 1979 and 2002, Chinese real GDP grew from \$177 billion to \$1.24 trillion (2002 prices) (6th largest GDP in the world) and real GDP per capita grew from \$183 to \$980. The U.S. GDP (approximately \$10.5 trillion) and GDP per capita (approximately \$37,000) are respectively more than 8 and 37 times the comparable Chinese figures in 2002.
- ◆ China survived the East Asian currency crisis relatively unscathed.
- ◆ Despite the SARS epidemic, the rate of growth of real GDP in 2003/Q2 was 6.7%, YoY, the lowest for the same period since 1992. The rate of growth in 2003/H1 was 8.2%. For the year as a whole, the rate of growth should easily attain 7.5%.
- ◆ China is one of the very few socialist countries that have made a successful transition from a centrally planned to a market economy—the 10th Five-Year (2001-2005) Plan is only indicative and not mandatory; the rate of interest (the price of money) and the exchange rate are the only prices that are still administratively determined on the margin.

The Chinese Economy Today (2)

| | 1979 | 2002 |
|---------------------|-----------|---------------|
| | US\$ | (2002 prices) |
| Real GDP | 177 bill. | 1.24 trill. |
| Real GDP per capita | 183 | 980 |

The Chinese Economy Today (3)

| | U.S. | China |
|---------------------|-----------------------|-------------|
| | US\$ (current prices) | |
| 2002 GDP | 10.5 trill. | 1.24 trill. |
| 2002 GDP per capita | 37,000 | 980 |

The Chinese Economy Today (4)

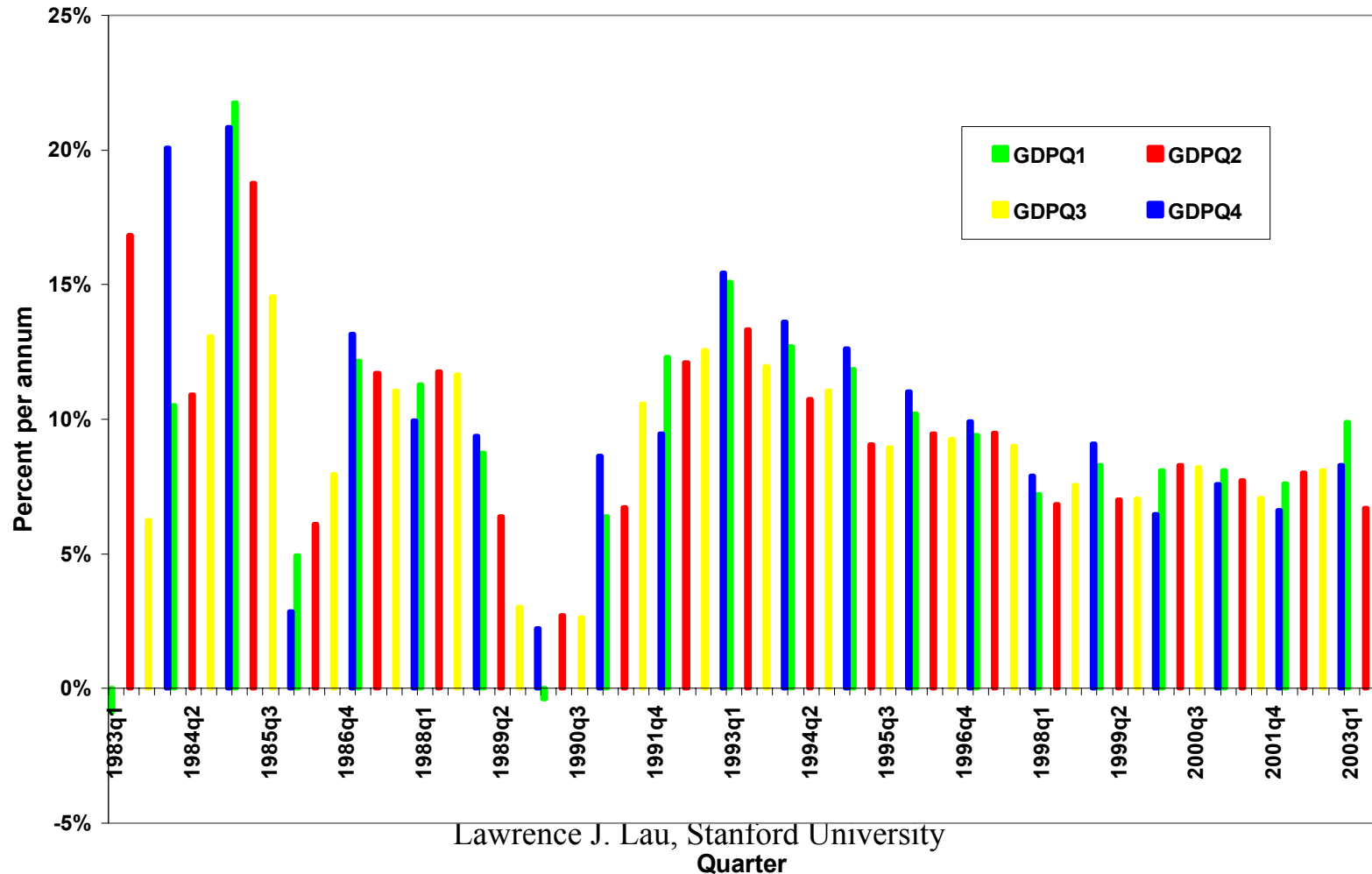
- ◆ The private (non-state) sector accounts for more than 65% of GDP and an even greater percentage of employment in 2002—non-state-owned firms face hard budget constraints and ordinary citizens can make a good living without being beholden to the state.
- ◆ China is no longer a “shortage” economy--insufficient aggregate demand is a real possibility.
- ◆ China is the 6th largest trading country in the world (exports of goods of US\$325.6 billion—an increase of 22.3% over 2001—and imports of goods of US\$295.2 billion—in increase of 21.1%— totaling US\$620.8 billion in 2002). In 2003/H1, despite the SARS epidemic, Chinese exports grew 33.6% YoY.
- ◆ Trade with East Asian economies, both exports and imports, have been increasing at rates of 20% and higher. In particular, China has become a major export destination for and has trade deficits vis-à-vis most East Asian economies.
- ◆ Chinese accession to the World Trade Organization has been very smooth; many anticipated negative effects have not occurred. The WTO General Council has said that “China has basically completed the commitments and obligations for the first year.”

Rates of Growth of Real GDP and Inflation (% p.a.)

| ◆ Actual | Real GDP | RPI | CPI |
|----------|----------|------|------|
| 1997 | 8.8 | 0.8 | 2.8 |
| 1998 | 7.8 | -2.6 | -0.8 |
| 1999 | 7.1 | -2.9 | -1.3 |
| 2000 | 8.0 | -1.5 | 0.4 |
| 2001 | 7.3 | -0.8 | 0.7 |
| 2002 | 8.0 | -1.3 | -0.8 |
| 2003Q1 | 9.9 | | 0.5 |
| 2003Q2 | 6.7 | | 0.7 |
| 2003H1 | 8.2 | | 0.6 |

Quarterly Rates of Growth of the Real GDP of the Chinese Economy, Y-o-Y

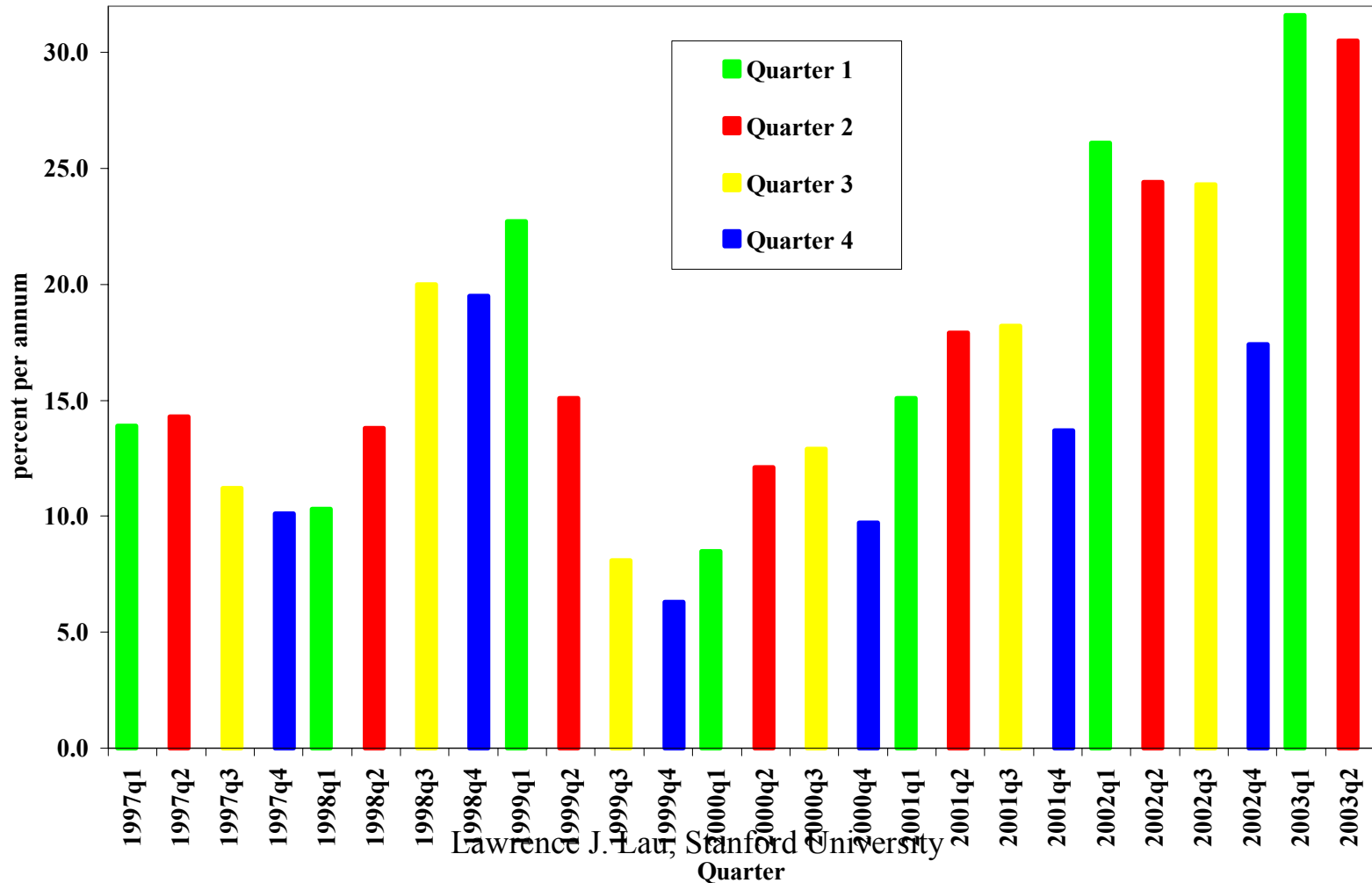
YoY Quarterly Rates of Growth of Real GDP



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Quarter

Quarterly Rates of Growth of Real Gross Fixed Investment of the Chinese Economy, Y-o-Y

YoY Quarterly Rates of Growth of Real Gross Domestic Fixed Investment



Has “Deflation” Stopped?

- ◆ Deflation has slowed. In 2003Q1, the rate of growth of the consumer price index (CPI) is a positive 0.5%. In 2003/M1-4, the rate of growth of the CPI was 0.6% YoY.
- ◆ The “core” rate of inflation is non-negative
 - ◆ The decline in prices over the past few years was due in part to the fall in the prices of energy, in particular oil, and agricultural products, in particular food.
 - ◆ It was also due in part to the increase in productivity (reduction in cost) and in competition, the decrease in the degree of monopolistic market power (reduction in profit margin), and more recently by the decrease in prices induced by realized and expected import tariff reductions mandated by the accession agreement to the WTO.
 - ◆ The long-term core inflation rate--inflation rate net of changes in the prices of energy and food--may be estimated at between 0 and 1 percent--there is no deflation.
 - ◆ The key to determining whether there is deflation in the classic macroeconomic sense is whether the components of aggregate demand—real consumption and investment—are growing. They have been growing at respectively 10.2% and 16.1% in 2002. In 2003Q1, gross fixed investment grew 31.6% YoY.
- ◆ Lack of upward pressure on the wage rate of unskilled labor and hence on the price level.
- ◆ The target for the growth of the money supply for 2003 is 16%. In April, 2003, M1 grew 18%. M2 grew 19.2%, 20.2% and 21% YoY in April, May and June respectively.
- ◆ The People’s Bank of China may raise the reserve ratio from 6% to 8% if the growth of credit continues to exceed the target.

Exports, Imports and Foreign Exchange Reserves

- ◆ In 2002, exports of goods totaled US\$325.6 billion (an increase of 22.3% over 2001) and imports of goods US\$295.2 billion (an increase of 21.1%) with a trade surplus of US\$30.4 billion (the current account surplus, including trade in both goods and services, was US\$35.4 billion).
- ◆ In 2003/H1, exports increased 34% YoY to US\$190.3 billion and imports increased 44.5% to US\$185.8 billion, resulting in a trade surplus of US\$4.5 billion (a decline of US\$8.9 billion from the same period in 2002). In 2003/Q1 there was a trade deficit of US\$1 billion, the first quarterly trade deficit since 1993. It is anticipated that there will be a trade deficit in the low to middle single digits for the entire year (it will be the largest annual trade deficit since 1993).
- ◆ Chinese tourists traveling abroad reached 16.6 million in 2002, an increase of 36.8% from 2001; 10 million Mainlanders are expected to visit Hong Kong in 2003, and the rate of growth is projected to be 20% per annum over the next five years. Chinese tourists are in general big spenders. The tourism component of the balance of payments turned negative in 2000 and remained so.

Exports, Imports and Foreign Exchange Reserves

- ◆ Official foreign reserves continued to rise, reaching US\$212.2 billion and US\$286.4 billion as of the end of 2001 and 2002, respectively. These represent respectively increases of US\$46.6 billion and US\$74.2 billion over the previous year and much larger than the trade surpluses of US\$22.5 billion and US\$30.4 billion. The official foreign reserves also surpass total outstanding external loans (approximately US\$165 billion as of year end 2002) by a wide margin.
- ◆ At the end of 2003/H1, official foreign exchange reserves stood at US\$346.5 billion. The increase of more than US\$60 billion during 2003/H1 occurred despite a relatively small trade surplus.
- ◆ At the end of 2003/M4, foreign exchange deposits in Chinese financial institutions reached US\$148.6 billion, an increase of 5.4% YoY, out of which corporate deposits constituted US\$48.7 billion and savings deposits US\$90.2 billion.
- ◆ The exchange rate of the Renminbi vis-à-vis the U.S. Dollar has remained stable since 1994 (in fact, there has been a slight appreciation from 8.7 Yuan/US\$ to 8.28 Yuan/US\$) and is expected to remain so. (Trading in non-deliverable one-year forwards (NDFs) suggests that the expected exchange rate is 8.137 Yuan per US\$.)

The Relative Stability of the Rate of Growth of Real GDP

- ◆ Gross domestic investment is mostly financed through domestic savings rather than foreign investment or loans.
- ◆ Foreign direct investment (FDI) accounts for approximately 10% of gross domestic investment in China, a relatively small proportion.
- ◆ Despite fluctuations in exports and imports, the rate of growth of real GDP has remained remarkably stable at 7-8%. Exports are approximately 25% of GDP, but the value-added content of exports is only approximately 30%, resulting in an export-generated value-added to GDP ratio of 7.5%. Chinese exports to the U.S. is approximately 8% of Chinese GDP (according to adjusted U.S. data), with a value-added content of 20%, resulting in a value-added to GDP ratio of 1.6%.
- ◆ The contribution of net exports of goods and services to the economic growth of 2002 is approximately 1% but is likely to be negative for 2003. The volatility of the Chinese annual rates of growth has also declined over time, indicating an improved capacity for macroeconomic management.

Foreign Direct Investment (FDI)

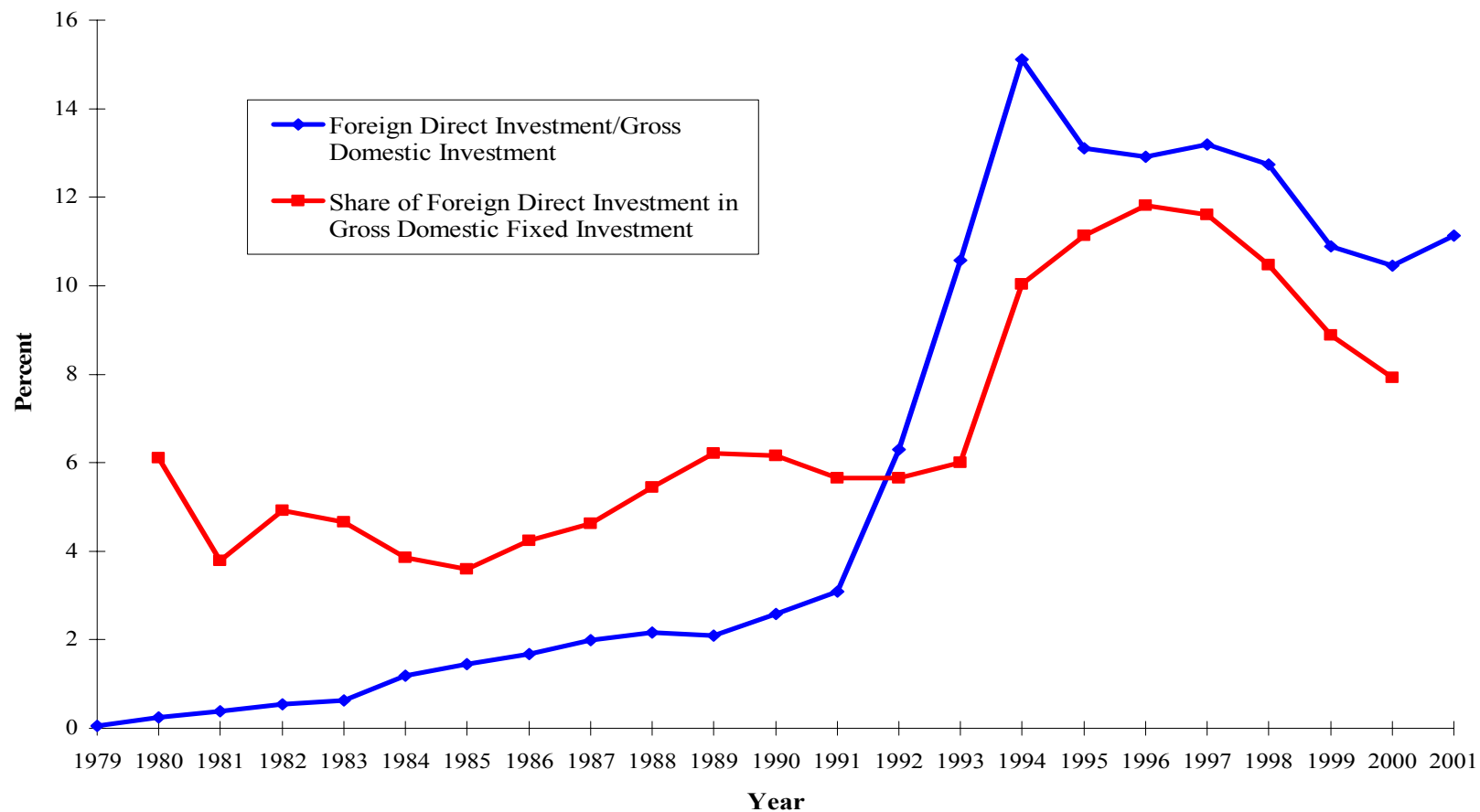
- ◆ FDI, at US\$60 billion a year, amounts to approximately 10% of the annual Chinese aggregate gross domestic investment of approximately US\$500 billion. Moreover, a significant proportion of it is what is known as “recycled” or “round-tripped” investment ultimately originated by Chinese entities and individuals. Quantitatively, FDI is not critical to the Chinese economy.
- ◆ Cumulative FDI at year end 2002 amounted to US\$ 448.17 billion
- ◆ Qualitatively, FDI is probably more important because it brings in technology, know-how, business methods, management techniques and markets that will otherwise be unavailable in China.
- ◆ China became the World’s leading recipient of FDI for the first time in 2002, with US\$52.7 billion, overtaking the United States with approximately US\$44 billion. However, its share of total World FDI is still relatively low—approximately 10%. (The U.S. was the largest recipient of FDI in the world in 2001, with US\$124 billion.)
- ◆ FDI has been responsible for most of the growth of exports (and imports). However, the nature of FDI has also changed--from export-oriented to domestic-market oriented; from light industry to heavy and high-technology industries; and from small projects to large projects.
- ◆ China as the World’s Factory as well as the World’s market.

China's Gross Domestic Investment as a Percent of GDP



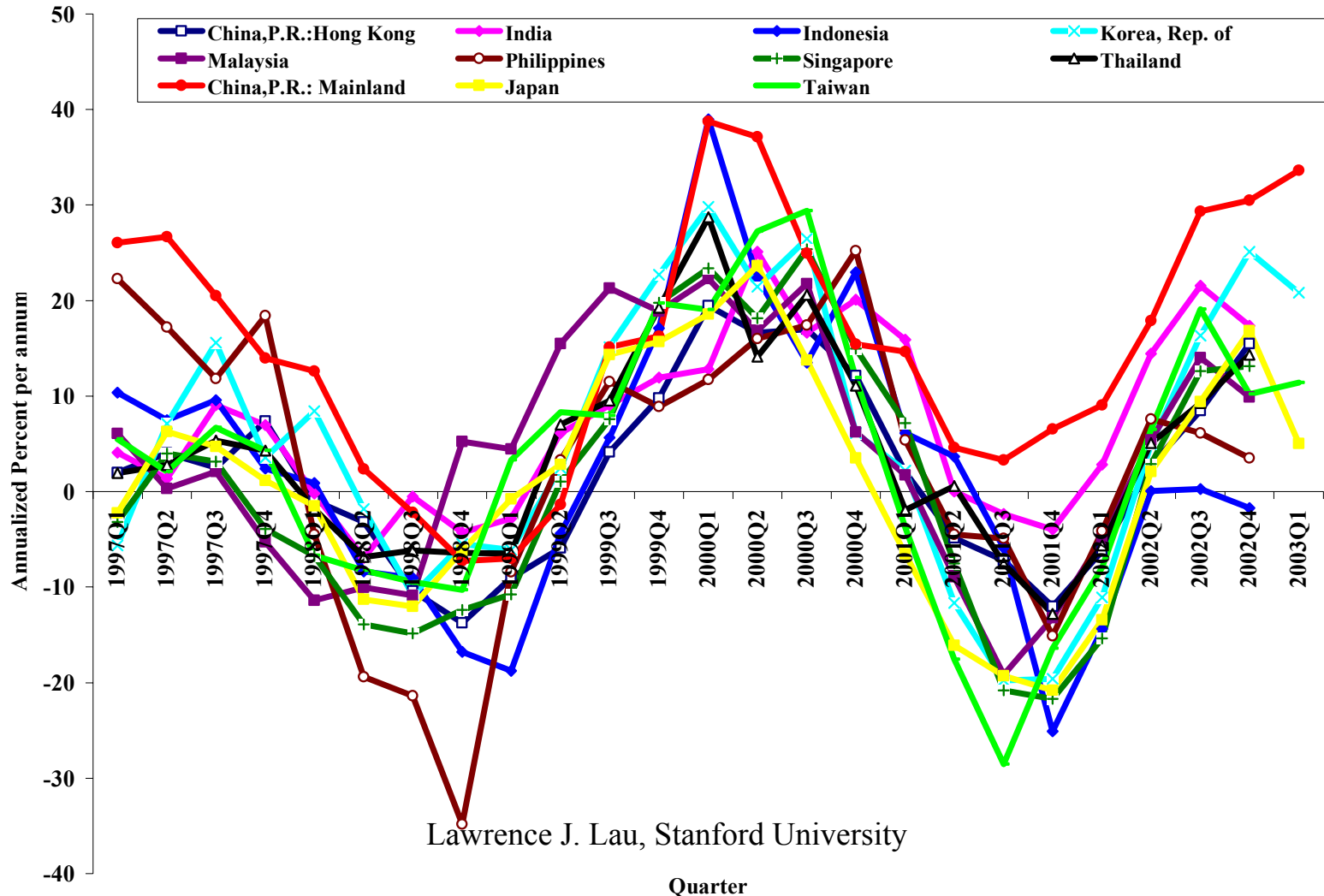
The Shares of FDI in Chinese Gross Domestic and Gross Domestic Fixed Investment

Fig. 1.2. The Share of Foreign Direct Investment in China (Percent)



Quarterly Rates of Growth of Exports: Selected East Asian Economies

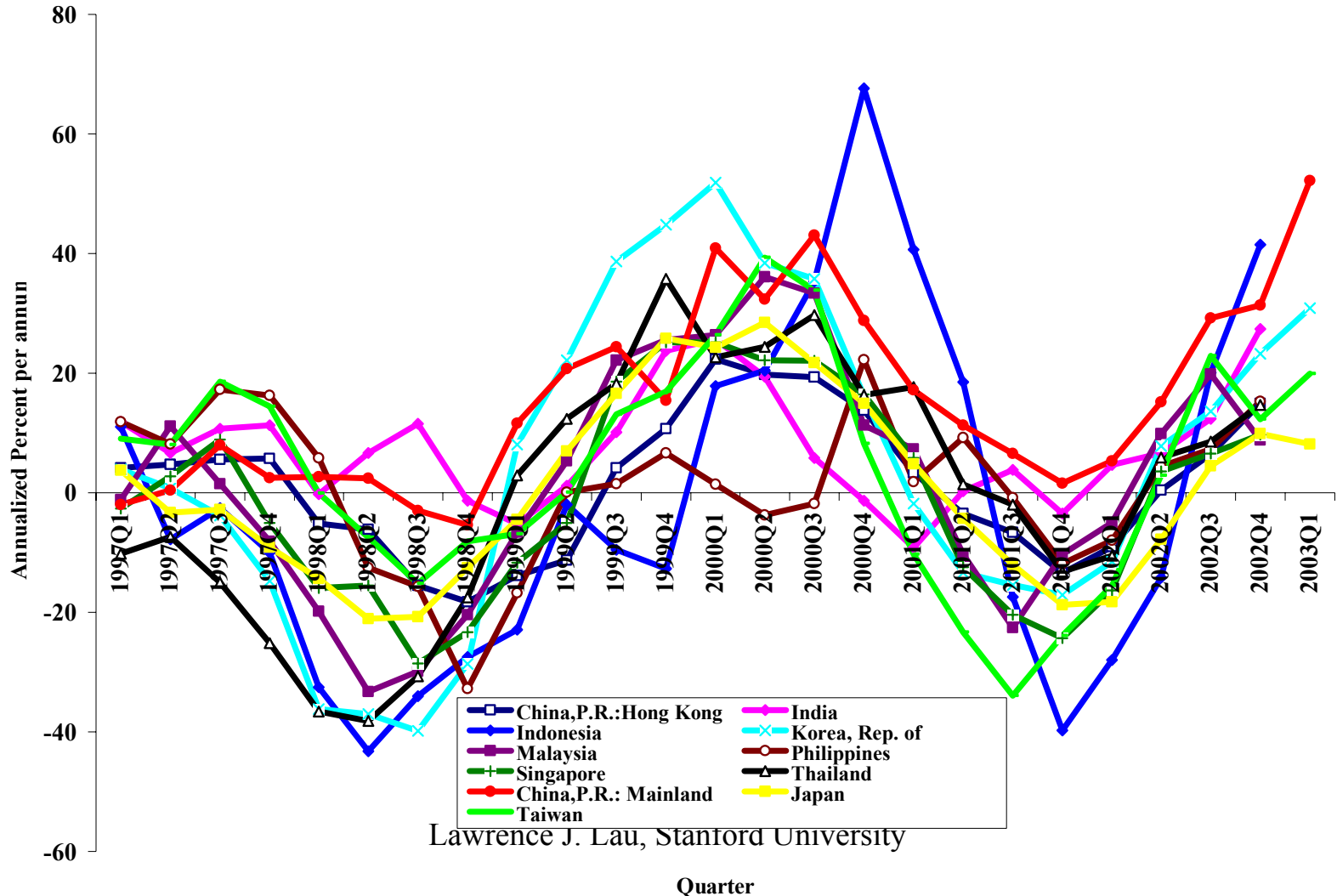
Year-over-Year Quarterly Rates of Growth of Exports in U.S.\$ (Percent)



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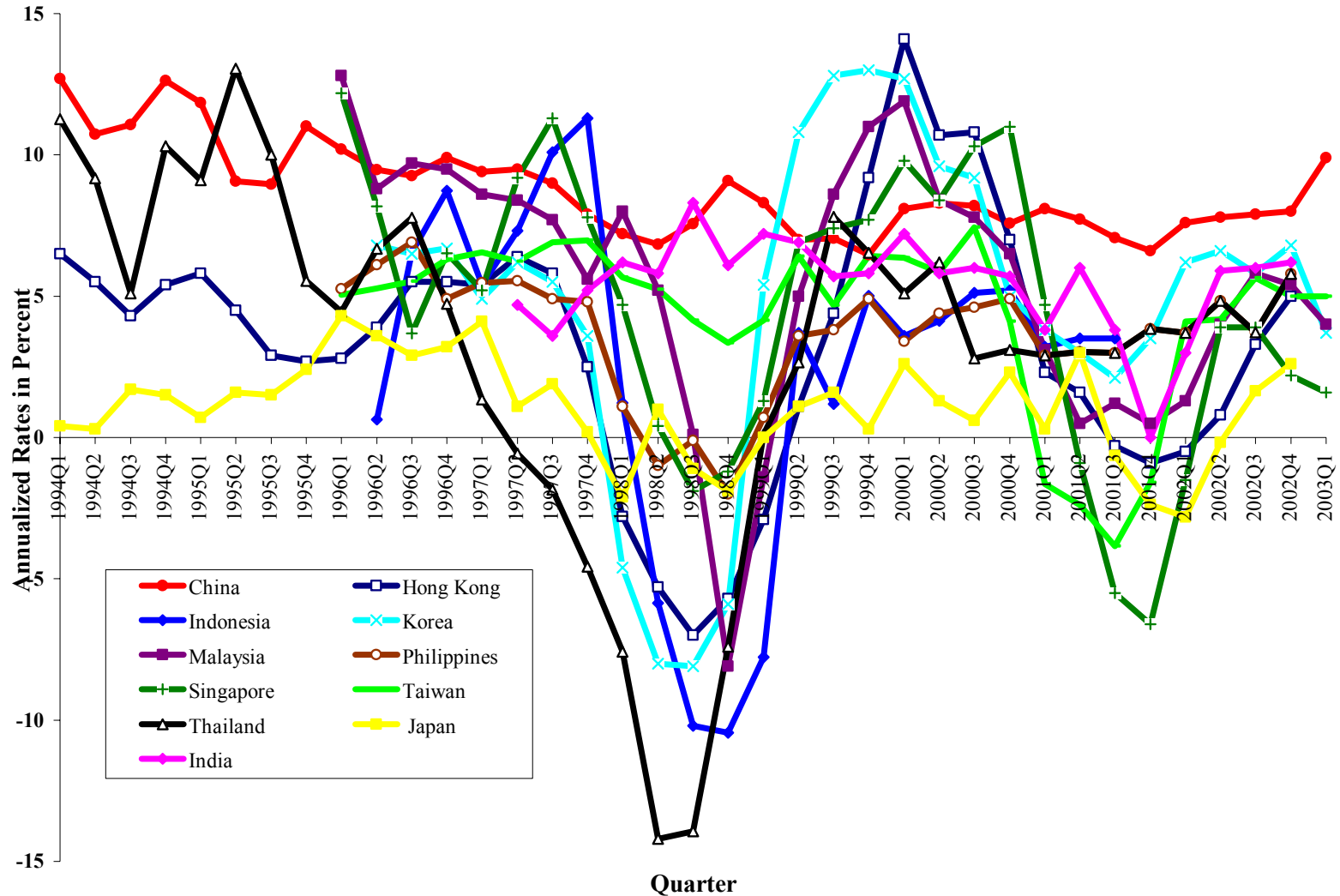
Quarterly Rates of Growth of Imports : Selected East Asian Economies

Year-over-Year Quarterly Rates of Growth of Imports in U.S.\$ (Percent)

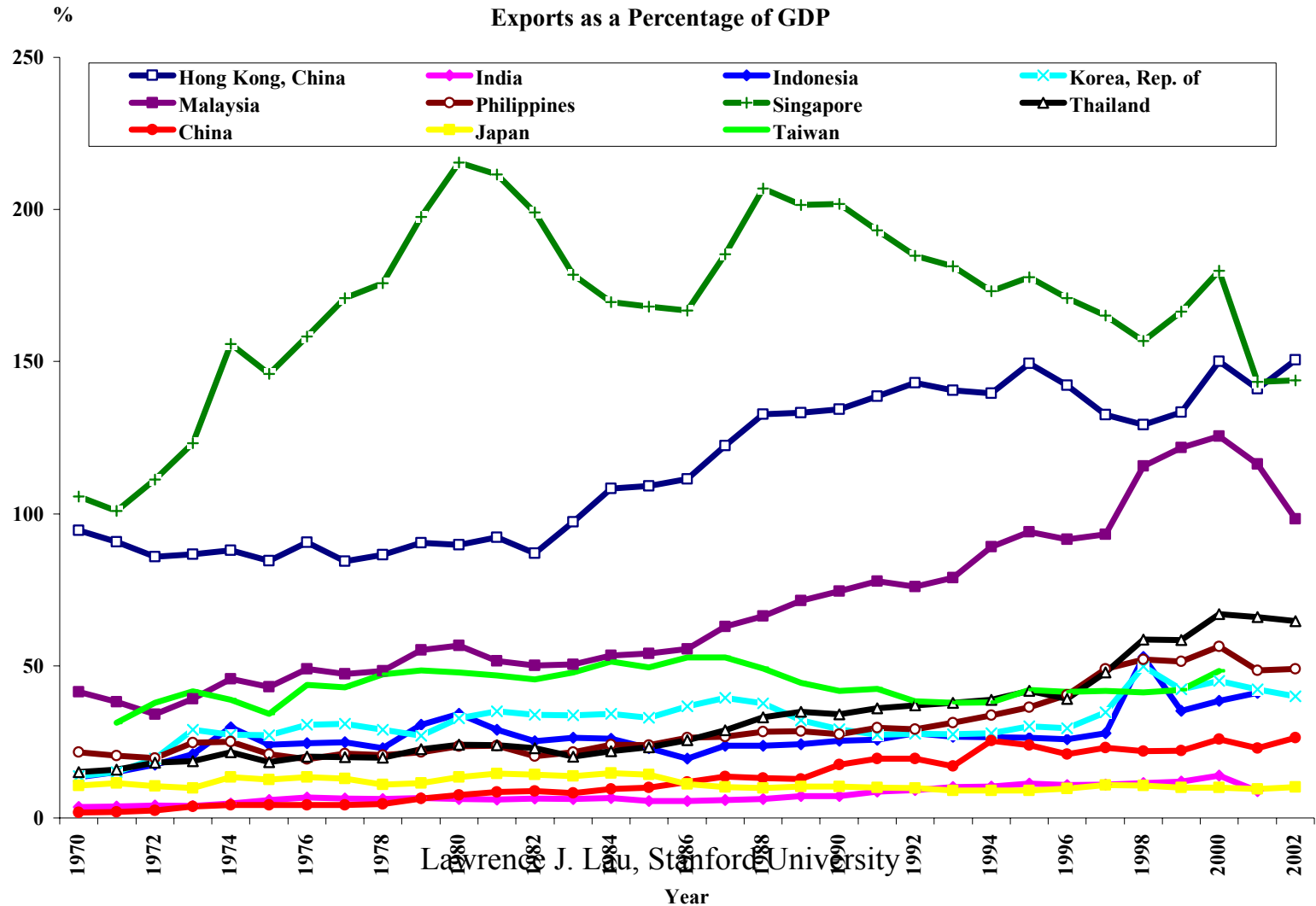


Quarterly Rates of Growth of Real GDP: Selected East Asian Economies

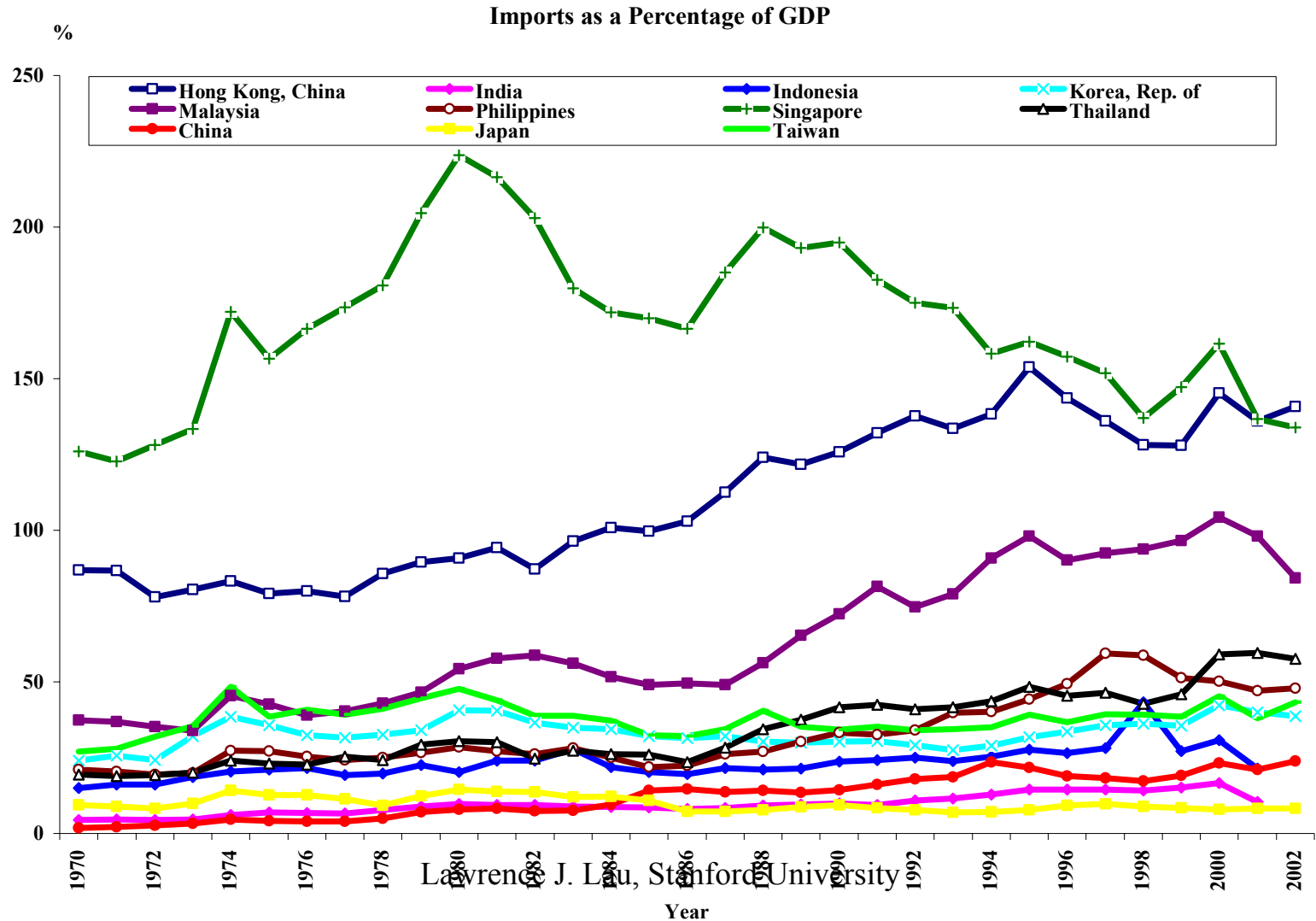
Quarterly Rates of Growth of Real GDP, Year-over-Year, Selected East Asian Economies



Exports as a Percent of GDP: Selected East Asian Economies and U.S.



Imports as a Percent of GDP: Selected East Asian Economies and U.S.



The Sixteenth Party Congress and the Transfer of Power

- ◆ The Sixteenth Party Congress in November, 2002 and the more recent Tenth National People's Congress went mostly smoothly and as expected—with Mr. HU Jintao assuming the positions of President of the People's Republic of China and the General Secretary of the Chinese Communist Party and Mr. JIANG Zemin retaining the chairmanship of both the State and the Party Military Commissions.
- ◆ What was unexpected was the expansion of the Standing Committee of the Politburo of the Chinese Communist Party from seven to nine members—indicating a jockeying for power among the different groups.
- ◆ Young, better educated technocrats have moved up to ministerial ranks.
- ◆ Both Mr. HU Jintao, the new President and General Secretary, and Mr. WEN Jiabao, the new Prime Minister, have adopted new styles and tried to project new images of openness, people-friendliness, pragmatism and respect for the rule of law. They appear to have gained the support of the rank and file (their confirmation votes at the Tenth National People's Congress were overwhelmingly in favor):
 - ◆ They emphasize their concern for the poor and the weak
 - ◆ They support greater transparency and accountability—public announcement of meetings of the Standing Committee of the Politburo; greater flexibility and tolerance for the media (especially in the aftermath of SARS)
 - ◆ They advocate frugality and no frills, e.g., abolish the send-off and welcome ceremonies for leaders of the party and the state on their foreign trips

The Sixteenth Party Congress and the Transfer of Power

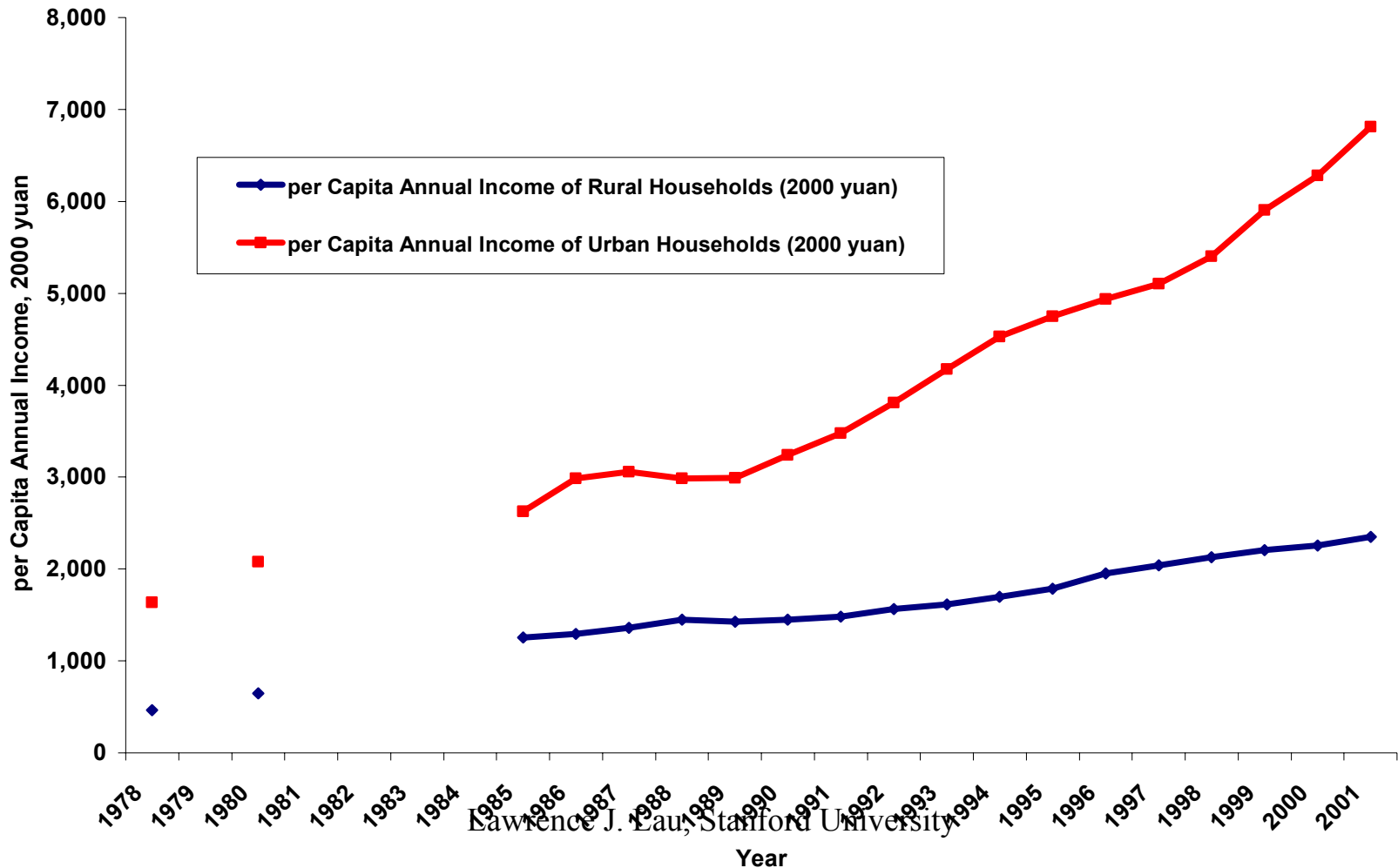
- ◆ Economically, the policy of reform and liberalization will continue—the objective is to quadruple Chinese real GDP by 2020.
- ◆ Politically, there will be efforts on the part of the Chinese Communist Party to recruit new members from all walks of life and not just from the peasants and the proletariat (the “Three Represents”)—but there will be both risks and rewards.
- ◆ Diplomatically, the policy of a low international profile will also be continued; there will also be increased efforts to strengthen the ties between the PRC and the other East Asian countries, both diplomatically and economically—e.g., The China-ASEAN Free Trade Area.

Building a Moderately Well-Off (Xiaokang) Society by 2020

- ◆ The goal of the Chinese Government is a quadrupling of real GDP between 2000 and 2020, implying an average annual rate of growth of real GDP of approximately 7.2%.
- ◆ If this goal is achieved, Chinese GDP will grow to not quite US\$5 trillion in 2002 prices, or less than a third of the then expected U.S. real GDP. Real GDP per capita is expected to be just short of US\$3,500 in 2002 prices, compared to a projected U.S. real GDP per capita of approximately US\$50,000.
- ◆ Another goal is to redress the imbalance in the economic development between the urban and rural areas, and between the coastal and interior regions, and to reverse the trend of rising inequality in the income distribution and in social services.

Real Income per Capita of Urban and Rural Households

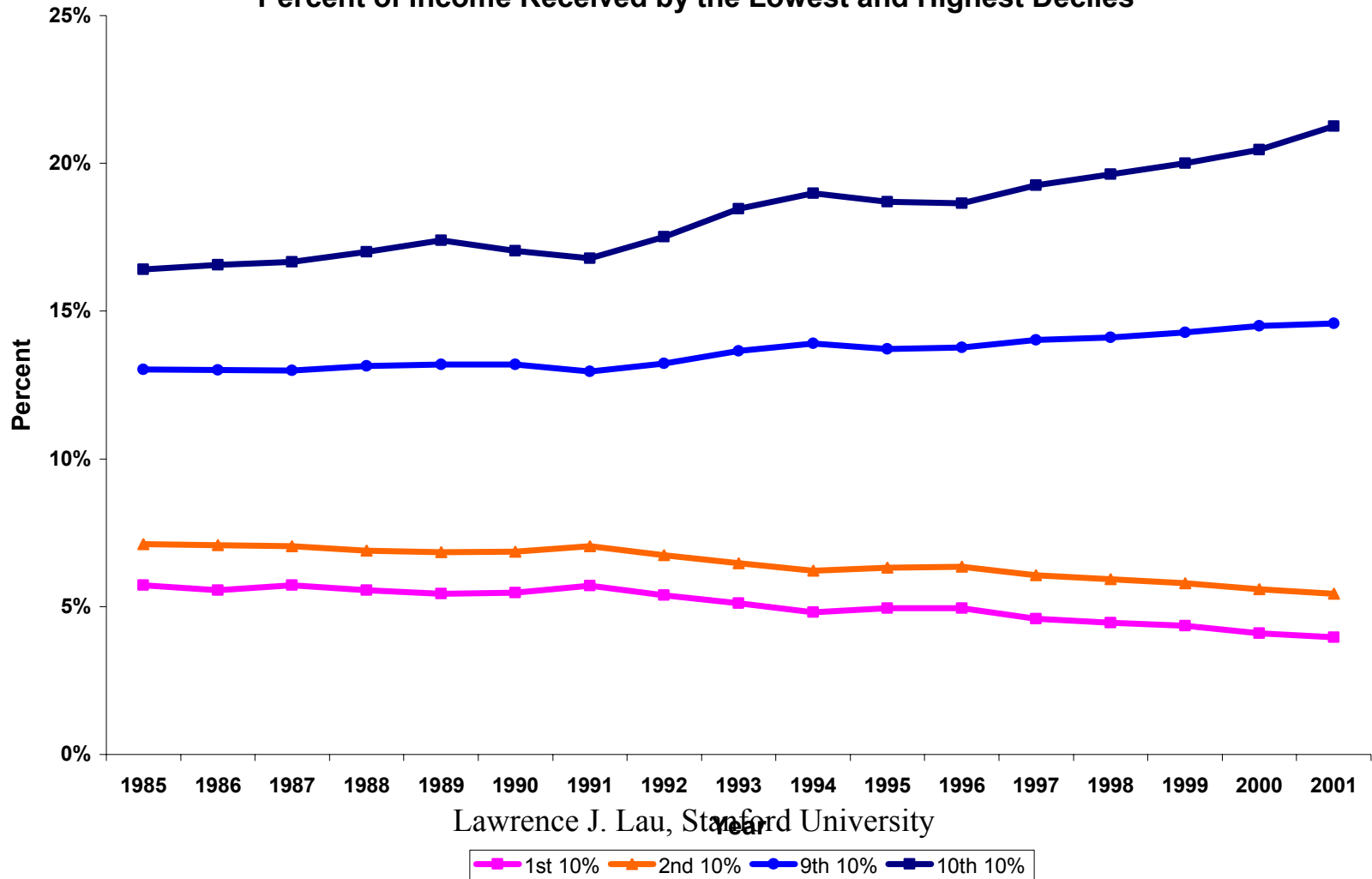
Comparison of per Capita Annual Income of Rural and Urban Households, 2000 prices



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The Distribution of Income among Urban Households in China

Distribution of Income among Urban Households:
Percent of Income Received by the Lowest and Highest Deciles



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The Economic Development and Reform Agenda of the New Administration

- ◆ Continuation of the twin policies of reform and openness.
- ◆ Economic reform to be focused on four areas:
 - ◆ Reform of state-owned enterprises (separation of the functions of ownership, regulation and supervision, and management)
 - ◆ Formation of the State-owned Assets Supervision and Management Commission (SASMC) to oversee 196 large enterprises with over US\$830 billion of assets in March 2003
 - ◆ Reform of the financial sector
 - ◆ Restructuring of the state-owned banks
 - ◆ Enhancing the capital markets
 - ◆ Reform of the agricultural sector
 - ◆ Relaxation of regulations on internal migration
 - ◆ Reform of the governmental institutions (substitution of indirect macroeconomic control and the market mechanism for direct microeconomic control; enhancement of the social security system)

Tasks Ahead

- ◆ Maintaining and increasing employment (moving labor from agriculture to industry and services)
- ◆ Implementing Chinese commitments under the accession agreement to the World Trade Organization (WTO)
- ◆ Establishing a credible and sustainable social safety net
- ◆ Socialization of basic social services such as education and healthcare
- ◆ Reform of the state-owned enterprises (SOEs)
- ◆ Reform of the banking and financial systems
- ◆ Integrating and unifying the domestic market
- ◆ Controlling corruption

The Critical Path for Continuing Economic Reform (1)

- ◆ In order to reform the Chinese commercial banking sector, the non-performing loans (NPL) problem of the state-owned commercial banks must be resolved.
- ◆ In order to resolve the NPL problem of the Chinese commercial banks permanently, it is necessary not only to take care of the outstanding stock, but also to stop the continuing flow.
- ◆ In order to stop the flow, it is necessary to restructure the borrower enterprises, so that they are independently viable without relying on new loans afterwards.
- ◆ In order to insure the viability of the restructured SOEs, most of the existing obligations of the SOEs must be assumed by the central and local governments, i.e., “socialized,” or by the individual employees themselves.²⁹

The Critical Path for Continuing Economic Reform (2)

- ◆ Socialization of these obligations requires, in turn, the creation of a credible social safety net--a viable social security and pension system (including unemployment “insurance”) to take care of both the inherited historical problems and the future--and the provision of social services by the local governments instead of the SOEs.
- ◆ Provision of social services by the provincial and local governments instead of the enterprises requires an independent source of revenue, through either the sharing of revenue with the central government, the division/sharing of tax bases, and direct and indirect central government subsidies (e.g., through tax preferences).
- ◆ Thus, continued economic reform must start with the creation of a social safety net and the division/sharing of social responsibilities and revenue/tax bases.

Non-Performing “Loans” of the State-Owned Commercial Banks

- ◆ The four major state-owned commercial banks account for 67% of all deposits (approximately 20 trillion Yuan) and 61% of all loans (15 trillion Yuan) and 90% of the loans of the state-owned enterprises (SOEs). The total volume of loans at the four major commercial banks amounted to 8 trillion Yuan (or US\$967 billion).
- ◆ Non-performance is no surprise to either the lenders or the borrowers
- ◆ In terms of flows, they amount to 2-3% of GDP, comparable to government budget deficits in many countries
- ◆ In terms of stocks, they range from approximately a quarter of the outstanding loans, or approximately 2 trillion Yuan (US\$240 billion) (People’s Bank of China (PBOC)) up to US\$500 billion; in June 2003, Moody’s Investors Service estimates that the level of non-performing loans can be as high as 45% or 3.6 trillion Yuan (US\$430 billion) (IHT, June 27, 2003) and Standard and Poor estimated these non-performing loans to be US\$750 billion (IHT, June 24, 2003). As a percent of GDP, these estimates range between 20 and 60%.
- ◆ Average loan loss reserves are approximately 6% of total loans and hence approximately 13% of the non-performing loans.
- ◆ In the mid-1990s, four asset management companies (AMCs) were formed to assume 1.4 trillion Yuan (US\$169 billion) of NPLs from the four major state-owned commercial banks.

Non-Performing “Loans” of the State-Owned Commercial Banks

- ◆ Assuming that only 25% of the NPLs are ultimately recoverable, the bad debt provision required ranges between 15 and 45% of the current GDP of 10 trillion. (Auctions for the NPL portfolios have been held successfully recently with a recovery ratio of approximately 25%. Goldman Sachs used a recovery ratio of 40%.)
- ◆ More recent experience indicates that the recovery ratio may well be higher—the People’s Bank of China reported in October 2002 that the four asset-management companies have disposed of a total of US\$28.1 billion of non-performing loans and recovered US\$10 billion, or slightly more than 30%. Hua Rong Asset Management Company, which was formed to handle the non-performing loans of the Industrial and Commercial Bank of China (ICBC), sold US\$5.3 billion of non-performing loans and recovered US\$2.6 billion, or almost half. Similarly, Agricultural Bank of China, Bank of China, and the Construction Bank of China sold respectively US\$10 billion, US\$4 billion and US\$9 billion worth of non-performing assets.
- ◆ The recovery rate is not independent of the criteria used for the classification of the NPLs. It is reasonable to use a higher recovery rate if the estimated NPL ratio is higher.
- ◆ In May 2003, LIU Mingkang, Chairman of the China Banking Regulatory Commission, indicated that non-performing loans have been reduced from 26.12% of the total to 24.13% of the total as of year-end 2002. They are likely to be further reduced to 20-21% at the end of 2003. (The China Construction Bank recently announced that its NPL ratio was down to 12.91% at the end of 2003/H1.)

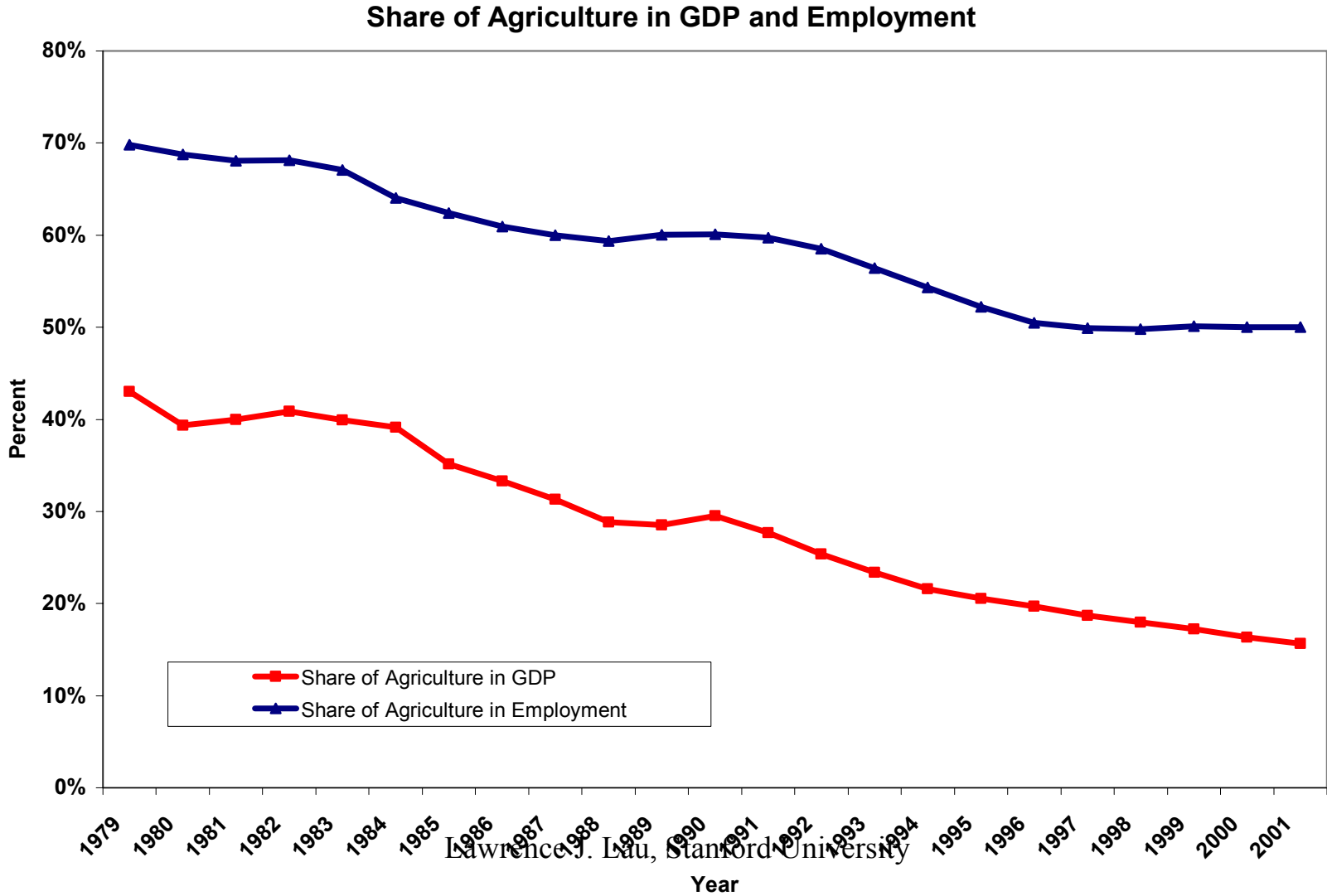
Non-Performing “Loans” of the State-Owned Commercial Banks

- ◆ The loans should be regarded as indirect loans to the central government which also owns all of the major banks, i.e. public debt.
- ◆ Outstanding Chinese national debt is approximately 18% of GDP (compared to 60-70% for the United States, 140% for Japan, 75% for Zone Euro and 160% for Belgium).
- ◆ Total public debt, assuming the conversion of all non-recoverable non-performing loans into public debt, may be estimated to be approximately 35-55% of Chinese GDP.
- ◆ Vice Minister LOU Jiwei estimated that state assumption of the NPLs would have raised the public debt/GDP ratio by approximately 20 percentage points.

Privatization

- ◆ Provincial and local governments can dispose of their shares in the local enterprises, including selling them to other investors, both domestic and foreign.
- ◆ The central government maintains control over approximately 190 large state-owned enterprises under its recently established State Assets Management Commission.
- ◆ The central government will issue rules on the sale of government shares.
- ◆ A more promising target for merger and acquisition activities is the foreign-invested enterprises, either joint ventures or wholly-owned. Many of the initial shareholders in these enterprises are ready to take their profits.
- ◆ Labor retention, disclosure and transparency, warranties and representations, as well as indemnification, remain important issues in these transactions.

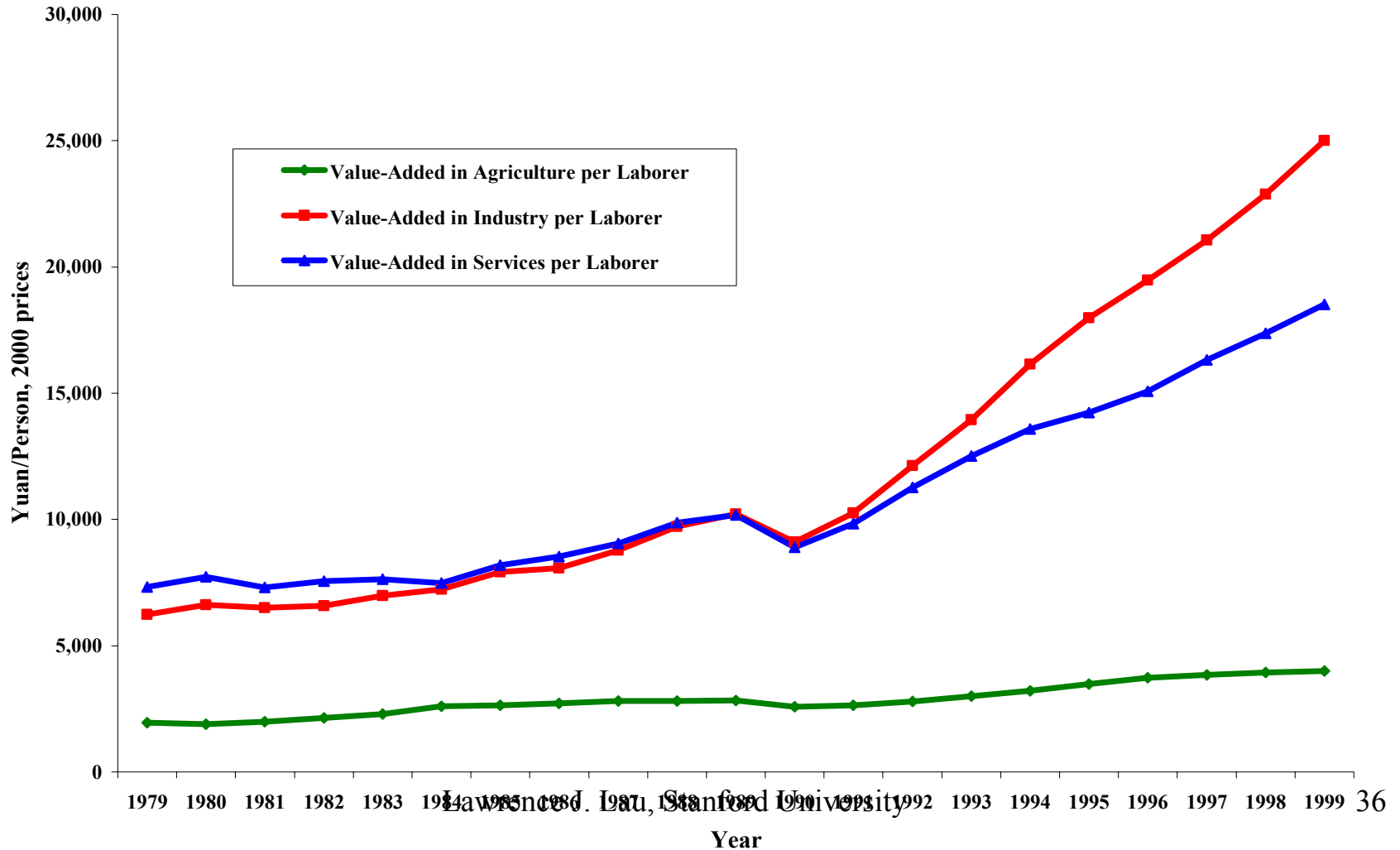
The Share of Agriculture in GDP and Employment



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Comparison of Values-Added per Laborer in Agriculture, Industry and Services

Value-Added per Laborer by Sector, 2000 prices



Industrialization and Urbanization (1)

- ◆ The share of agriculture (primary sector) in GDP has declined from 43% in 1979 to less than 16% in 2001. Over the same period, the share of agriculture in employment has declined from almost 70% to 50% but appears to have stalled for the past few years.
- ◆ Given the large and increasing gap between the value-added per laborer in the agricultural and non-agricultural sectors, the transformation of the economy from agriculture to industry (and services) is inevitable in order that real GDP per capita can continue to rise. Historically, no large economy has successfully achieved a high level of real GDP per capita without a massive shift of the population and labor force out of agriculture.
- ◆ Industrialization and urbanization are complementary— industrialization (or more broadly the growth of the non-agricultural sector) requires urbanization and urbanization facilitates industrialization.

Long-Term Economic Growth: Three Paradigms of Chinese Economic Growth

- ◆ Domestic demand-driven growth--the domestic market paradigm a la the United States in the 19th century. China is a large continental economy--International trade will never be as important as other, smaller countries and China must rely on internal demand for further economic growth. Value-added from exports constitutes only 7.5 percent of Chinese GDP.
- ◆ The "wild-geese-flying pattern" metaphor of East Asian industrial migration over time can apply to Chinese provinces and regions
- ◆ Privatizing the economy without privatization--shrinking the state sector through the growth of the non-state sector in the absence of explicit privatization--the experience of Taiwan and South Korea
- ◆ What does it take?
 - ◆ Availability of infrastructure (transportation and communication, including the internet)
 - ◆ Continued marketization of the economy
 - ◆ Maintenance of a domestically open economy (the equivalent of the "interstate commerce" clause of the U.S. constitution)
 - ◆ Affirmation of tangible and intangible property rights and the rule of law (a national commercial and tax court?)
 - ◆ Maintenance of an internationally open economy--the role of the "open door" (WTO)

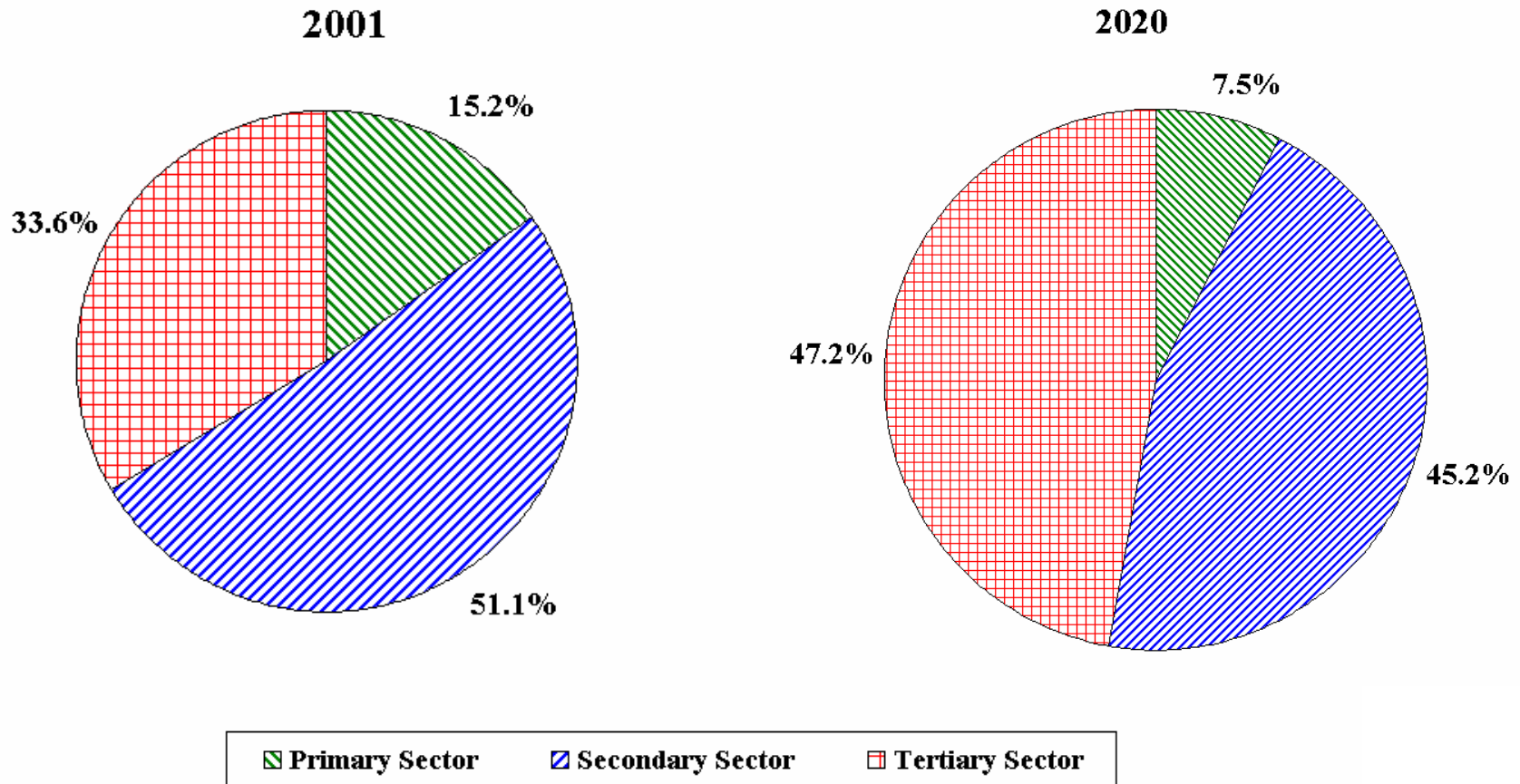
Prospects for Economic Growth

- ◆ Chinese economic growth during the next five years, indeed the next decades, will depend mostly on internal factors and be largely unaffected by the policies of other countries or events outside of China (a disruption of the oil supply may be an exception).
- ◆ There are numerous serious problems confronting the Chinese economy—however, these problems are not intractable.
- ◆ On the margin, foreign involvement in the Chinese economy will make some, but not a critical, difference; but it can be mutually beneficial for both China and the foreign countries.
- ◆ Chinese GDP and GDP per capita will remain low relative to the industrialized economies (G-7) for at least three or more decades.
- ◆ The share of Chinese GDP produced by the non-state-owned sector will rise from 65% to 80% in another decade.
- ◆ There is significant complementarity between the Chinese and G-7 economies--the G-7 economies do not export anything that China exports (and have not done so for decades) and China does not export anything that the G-7 exports. It is this complementarity that maximizes the potential gains from free trade between the two sides.

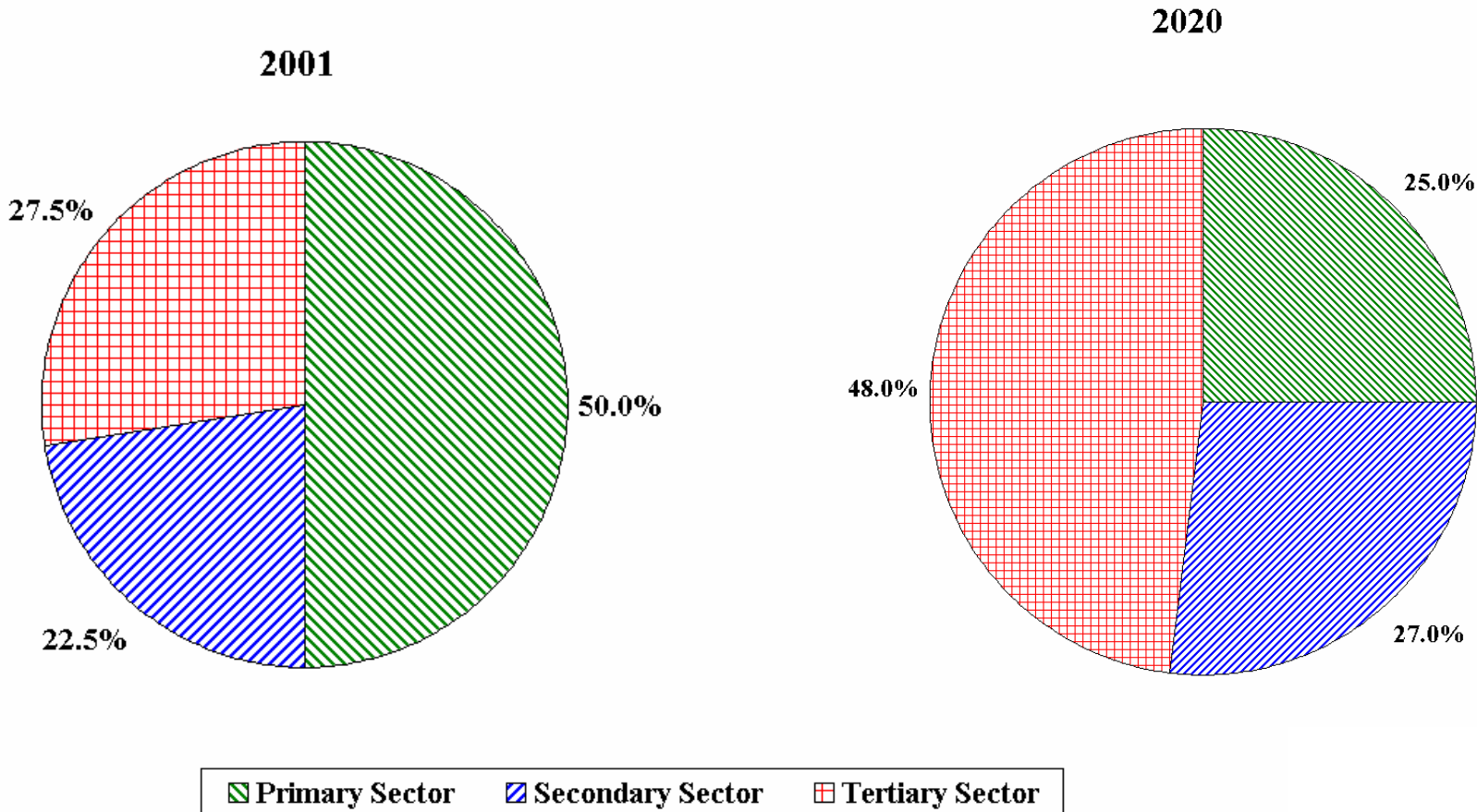
Long-Term Projections

| | 2002 | 2010 | 2020 |
|---------------------|--------------------|-------------|--------------|
| | US\$ (2002 prices) | | |
| Real GDP | 1.25 trill. | 2.25 trill. | 4.5 trillion |
| Real GDP per capita | 980 | 1,750 | 3,400 |

The Structure of the Economy: GDP



The Structure of the Economy: Employment



Sources of Growth of Aggregate Demand: Affordable Owner-Occupied Housing

- ◆ Huge pent-up demand for new affordable owner-occupied residential housing and rebuilt and renovated residential housing—a housing boom that can last for decades
- ◆ Promotion of affordable owner-occupied residential housing investment for and by the domestic population is one of the few alternative new and durable sources of growth of aggregate demand
 - ◆ Simultaneous adjustment of salaries and rents, providing purchasing power for employees not currently provided housing
 - ◆ Establishment of properties (transfer) rights to residential housing similar to those already available in the rural areas
 - ◆ Provision of long-term, preferably fixed rate, mortgages; development of secondary markets for such mortgages to avoid maturity mis-match; adoption of “safe-harbor” rules to overcome “reluctance to lend”
 - ◆ Institution of urban zoning and land use laws; absorption of land costs but maintaining fairness through land leases adjustable upon renewal
 - ◆ Development of mass urban transit
- ◆ Housing reform has taken root in major urban centers except Beijing

Sources of Growth of Aggregate Demand: Affordable Individual and Mass Transportation

- ◆ Huge pent-up demand for new affordable automobiles—annual domestic demand now estimated to be in excess of 2 million units.
- ◆ In 2003Q1, production of automobiles increased 120% YoY to almost 400,000 units; production of all motor vehicles increased 54% to 1.05 million units.
- ◆ In 2003/H1, production of passenger automobiles reached 903,000 units; production of all motor vehicles reached 2.126 million units, an increase of 32.2% YoY.
- ◆ Automobile assembly lines are now operating in 23 provinces, autonomous regions and municipalities.
- ◆ Huge need for mass transit in both old and new cities.

Sources of Growth of Aggregate Demand: Promotion of Science and Education in China

- ◆ Investments in information technology
 - ◆ Leap-frogging traditional development in telecommunication (the experience of the wireless phone)
 - ◆ E-commerce among enterprises
 - ◆ New models of marketing, distribution and sales
 - ◆ A PC in every classroom (in every urban home)
 - ◆ Set-top boxes on television sets with point and click device and numeric pad can link 400 million households to the internet
 - ◆ New modes of education and information dissemination
 - ◆ The Chinese language is uniquely suited to communication based on a graphic interface (the experience of the fax machine)
- ◆ Extension of compulsory education to 12 years
- ◆ Investments in tertiary education and in R&D

The Development of the Great West: Reducing Regional Inequalities

- ◆ Even though all regions benefited from the economic reform since 1979, the coastal regions benefited much more than the inland regions—there is an estimated 6 to 1 or even 8 to 1 ratio between the per capita GDP of the richest and poorest province/region.
- ◆ Interregional income inequality has risen, resulting in:
 - ◆ Dissatisfaction and restiveness
 - ◆ Deterioration of social services, especially education and health care
 - ◆ Massive illegal migration from the inland regions to the coastal regions, creating huge pressure on social and physical infrastructure
- ◆ Relaxation of rural-urban migration (mostly controlled by the local authorities)
- ◆ Transfer payments from the central government
- ◆ Raising agricultural incomes
- ◆ Urbanization in situ

The Development of the Great West: Reducing Regional Inequalities

- ◆ Moving jobs to where people are, not people to where jobs are
- ◆ Urbanization through the creation of new towns and cities, not the growth of existing towns and cities
- ◆ Developing a truly unified national market
- ◆ Education and investment in human capital is the most effective means for reducing income inequality
- ◆ Maintaining long-term competitiveness without devaluation; WTO accession can help by putting pressure on enterprises to move inland to lower their costs and maintain competitiveness
- ◆ Opening a new “Silk Road”—a direct land bridge to Europe and the relocation of the capital from Beijing to a city in the Western region of China can significantly accelerate the development of the Great West

The New Economy and China: The Advantages of Backwardness and Size

- ◆ The possibility of leap-frogging--there are no vested interests to protect; no existing businesses to be cannibalized; there can be “creation without destruction”
 - ◆ e.g., facsimile machines instead of telexes; video compact discs instead of VCRs; a new keyboard layout; mobile and wireless telephones instead of fixed lines; debit and credit cards instead of checks
- ◆ The possibility of influencing/setting standards--the markets are potentially large enough in China for the benefits of economies of scale to be realized and for it to have a significant influence on future standards
 - ◆ e.g., Linux; wireless telephone standards (CDMA)
- ◆ The possibility of local adaptation--taking advantage of local conditions
 - ◆ e.g., the Legend story—language; local supply and demand conditions, e.g., stability of the voltage of the electric power supply
- ◆ Transformation of the “Old Economy” through the information and communication technology

The New Economy Levels the Playing Field between Large and Small Firms

- ◆ Small firms can have access to services and supplies heretofore only available to large firms
 - ◆ E.g., by bringing down the cost of securities trading, Charles Schwab and E-trade benefit small investors proportionally much more than large investors
 - ◆ Rapid delivery services and warehousing facilities, e.g., Federal Express, are available to both large and small firms
- ◆ Small firms can also become more accessible to their customers and potential customers through the Internet with only marginal expenditures on advertising and public relations
- ◆ Small firms have access to large firms as potential suppliers in a global supply chain
- ◆ The Chinese economy with its high and potentially even higher concentration of smaller firms and more primitive information infrastructure (and thus the potential for leap-frogging) may benefit much more from the new economy than other more developed economies
 - ◆ E.g., B2B dot.coms seem to have relatively greater success in East Asia than in the United States

Difficult Issues

- ◆ Domestic stability—domestic stability can be maintained as long as the economy performs well and the gap between the have's and have-not's does not become too large. The agricultural procurement program, the establishment of the social security fund, the Western Development Initiative, and the renewed focus on education are all intended to address these issues.
- ◆ Acceleration of urbanization and industrialization (building new cities or enlarging old cities?)
- ◆ Centralization versus decentralization—power to raise and collect taxes, to issue debt, to regulate provincial and local commerce, to adjudicate and enforce the law (interstate commerce clause, national commercial and tax court)
- ◆ The reliability of information (e.g., GDP statistics, SARS)

Projected Rates of Growth of Real GDP and Inflation (% p.a.)

Projections of Rates of Growth of Chinese GDP and Inflation, 2003, % p.a.

| Organization | Pre-SARS | | Post-SARS | |
|--------------------------------------|----------|-----|-----------|-----|
| | GDP | CPI | GDP | CPI |
| National Bureau of Statistics, China | >7.0 | | >8.0 | |
| People's Bank of China | | | | 1-2 |
| Development Research Center, China | 7.0-8.0 | | | |
| Chinese Academy of Social Sciences | 8.6 | | 8 | |
| Asian Development Bank | 7.5 | | 7.3 | |
| The World Bank | | | 7.2 | |
| Citicorp. | 7.6 | | 6.7 | |
| Credit Suisse Frist Boston | 7.9 | | 7.3 | |
| Goldman Sachs | 7.5 | | 7 | |
| J. P. Morgan Chase | 8 | | 7.4 | |
| Morgan Stanley | 7 | | 6.5 | |
| UBS Warburg | 7.3 | | 7.3 | |
| Lau | 7.5 | 1 | 7.5 | 1 |

Recent Developments

- ◆ In 2003/Q2, real GDP grew at 6.7% YoY, brought down principally by the slowdown in the service sector, which grew only 0.8% YoY compared to 6.9% in 2002/Q2 (retail sales only grew 6.7% YoY compared to 9.2% in 2003/Q1).
- ◆ In 2003/H1, gross fixed investment grew 31.1% YoY, retail sales grew 8% YoY, and industrial value-added grew 16.4% YoY.
- ◆ In 2003/H1, exports grew 34% YoY, showing little impact of SARS.
- ◆ The SARS epidemic is finally over. The World Health Organization removed China from the list of SARS-affected areas in late June. There should be a relatively rapid recovery of the service sector.
- ◆ In 2003/H1, actual foreign direct investment (FDI) reached US\$30.3 billion, an increase of 34.3% YoY; committed FDI reached US\$51 billion, in increase of 40.3% YoY. However, the rate of increase of actual FDI was only 2.5% in 2003/M6, reflecting the effect of the SARS epidemic.
- ◆ The major economic impacts of SARS are likely to be in new business rather than on-going business. Thus, new committed FDI has shown a decline in the rate of growth. It will also impact the retail sector in the affected provinces and regions, and service sectors such as tourism, hotels, restaurants, and entertainment and recreational activities.

The Implications of the SARS Epidemic

- ◆ Information flow—the importance of multi-channel independent information.
- ◆ Emergency preparedness.
- ◆ Public education and awareness. Self-preservation and self-protection are the keys to stopping the transmission. That is why transparent and timely information are critical.
- ◆ An opportunity for the new administration to demonstrate its authority and effectiveness.