

The Real Challenges to China's High Growth: Think out of the box or risk being buried in it

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“India and China Rising: Issues and Impact on the Global Economy”
conference, Tokyo Club Foundation for
Global Studies, 6-7 December 2006

Putting People First

- 6th Plenum in October 2006 committed CPC to building a harmonious society
- Implication is that present major trends in society, economy and polity might not create a harmonious society which is defined as
 - a democratic society under the rule of law
 - a society based on equality and justice
 - an honest and caring society; and
 - a stable, vigorous and order societyin which humans live in harmony with nature
- Downplay objective of “prosperous society”

Analogy to Speeding Car

- Post-mortem on crash
 - Right front tire burst
 - Fight within car
 - Ran out of gas
- Jump in amount of social disorder; 1994 had 10,000 mass incidents involving 730,000 persons; and 2004 had 74,000 mass incidents involving 3.7 million persons
 - Dislocations from large reforms
 - Social protest only way to get real solutions from an unresponsive government
 - Rise in social expectations

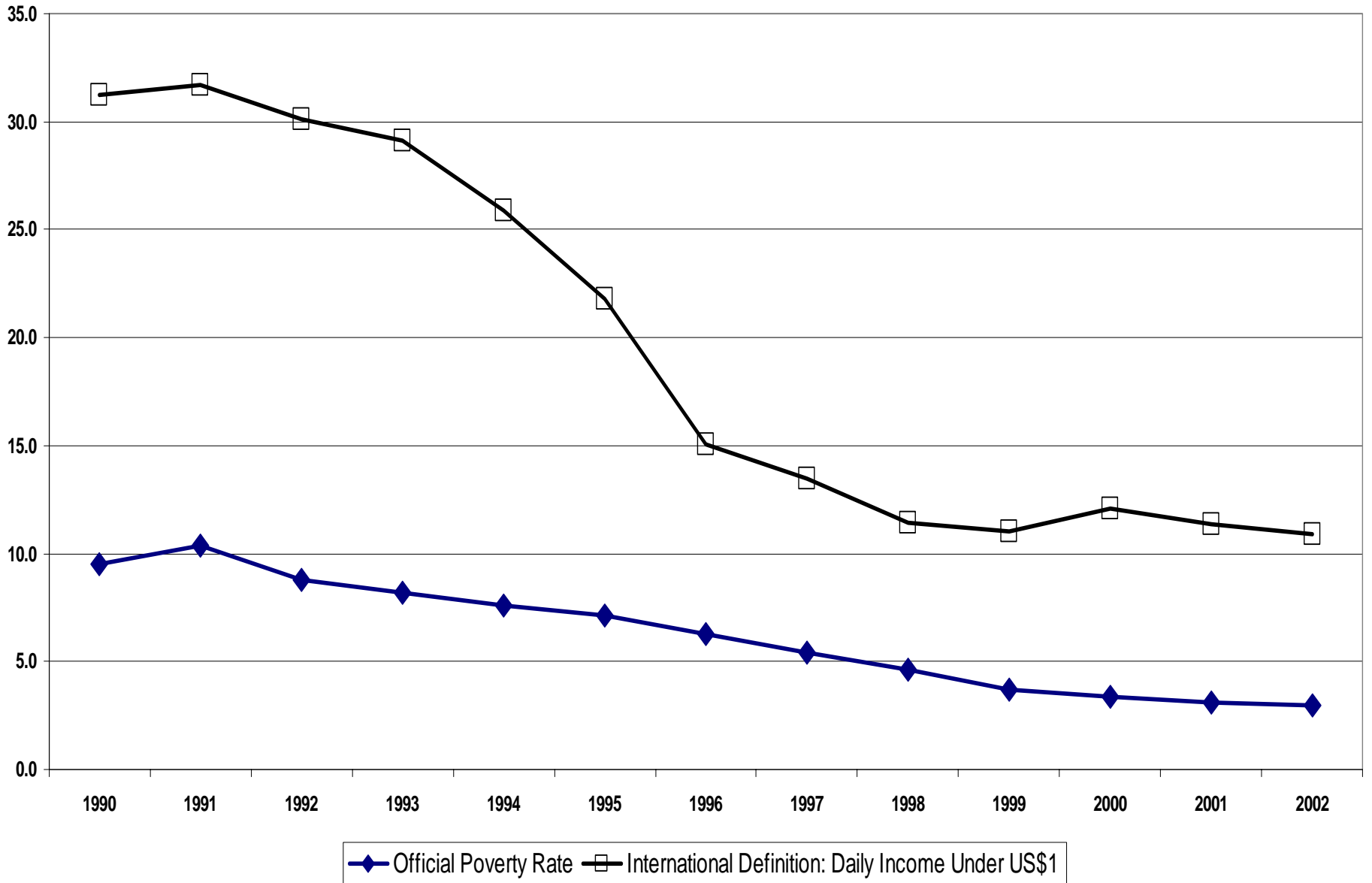
Highest-Probability Big Challenges

- Social disorder, e.g. governance difficulties
- Stagnant poverty and worsening inequality
- Environmental degradation
 - world's 20 cities with dirtiest air, 16 in China
 - northern drought, sinking 1 mm per year, 3 canals to transfer water from south to north
- Fiscal sustainability
 - constant recapitalization of state-owned banks
- Politically delegitimizing if corruption is seen as major cause of above 4 failures

Extreme Poverty and Inequality

- Post-1978 reforms have created much wealth, official poverty rate has fallen from 31% in 1978 to 9.5% in 1990, and then to 3% in 2002
- Use international definition of daily income below \$1, then poverty rate > 60% in 1978, 31% in 1990, 11% in 2002
- Problem is that absolute poverty rate has been stuck at 11% since 1998, see diagram.
- Avg income of rural poor fell from 72 cents in 1999 to 63 cents in 2002 + 2.5pct drop 2001-3

Rural Poverty Rate (in percent) 1990-2002



New Approach Needed

- Strength of trickle-down mechanism depends on
 - government policies
 - stage of economic development
- Quick reduction in poverty in 1978-1998 period is from provision of job opportunities, e.g. legalisation of private enterprises, export-processing activities
- Bulk of remaining absolute poverty is of different nature, hence rate stuck at 11% since 1998. More of the same will not work

New Methods to Reach the Poor

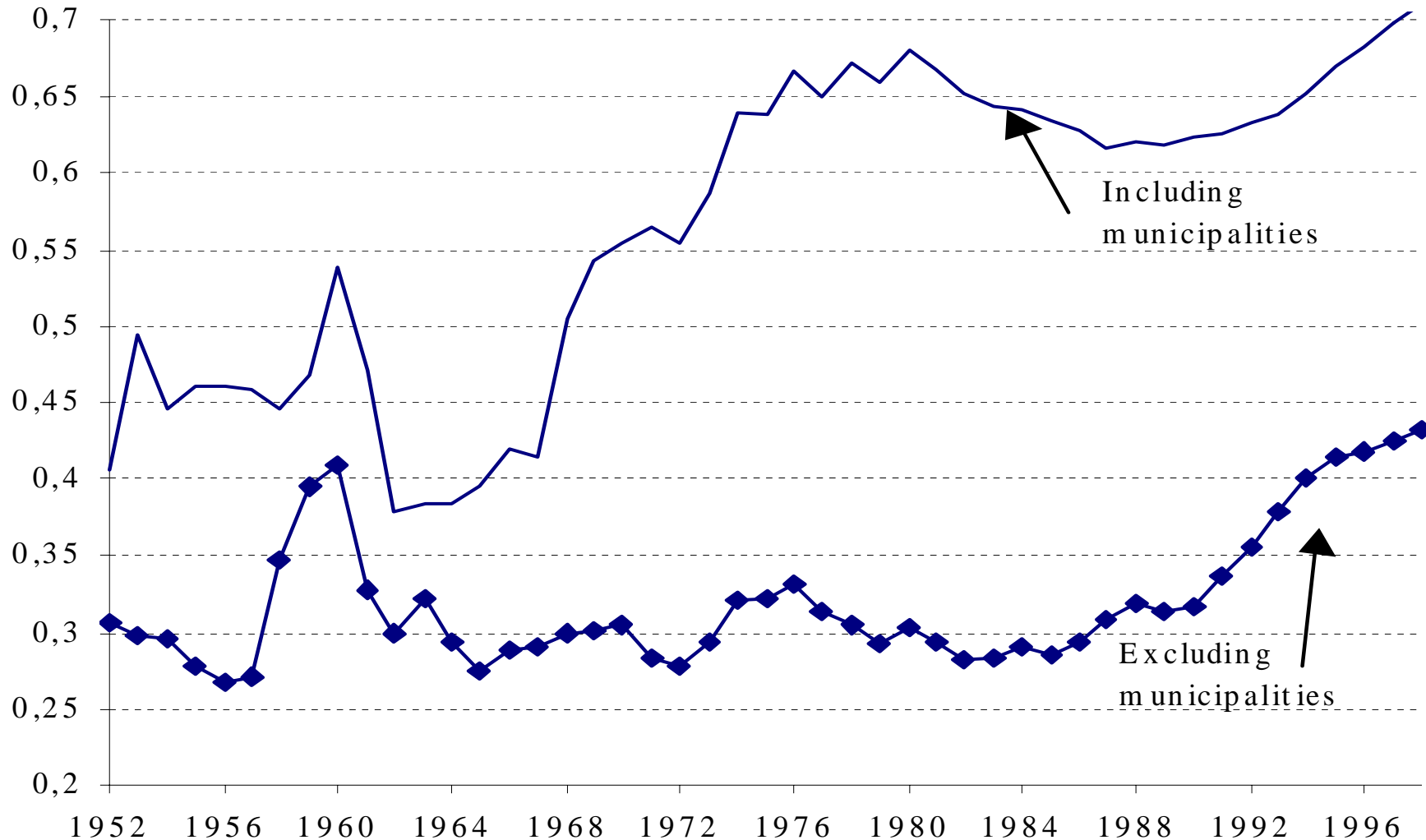
- Empowerment of the desperately poor to gain from job opportunities. Provide access to:
 - Low-cost healthcare: Illness is #1 generator of poverty. Sickly childhood, then more sick days as adult, and lower IQ
 - Education: Not just free tuition but also free lunch
 - parents will push kids to go school
 - Capital: Mohd Yunus received Nobel Peace Prize for pioneering micro-credit. Enhance this by giving land title to farmers to enable collateralisation of investment capital. *Communal land as social safety net? Taxes from increased wealth will finance more efficient social safety net*

Western China is Poorer and Lagging

- Absolute poverty is more pervasive in Western China (more rural), and regional income gap is widening, see diagram
- Income convergence in USA but not in China
- Strengthen traditional spillover mechanisms
 - labor flow from poor to rich, eliminate household registration system
 - capital flow, break monopoly state bank system
 - infrastructure to improve communication
- Introduce new mechanism of income propagation: advanced regional universities as regional growth poles. Science in the service of development.

Dispersion of Provincial Income, 1952-1998

(Coefficient of Variation, exclude Hainan and Tibet)



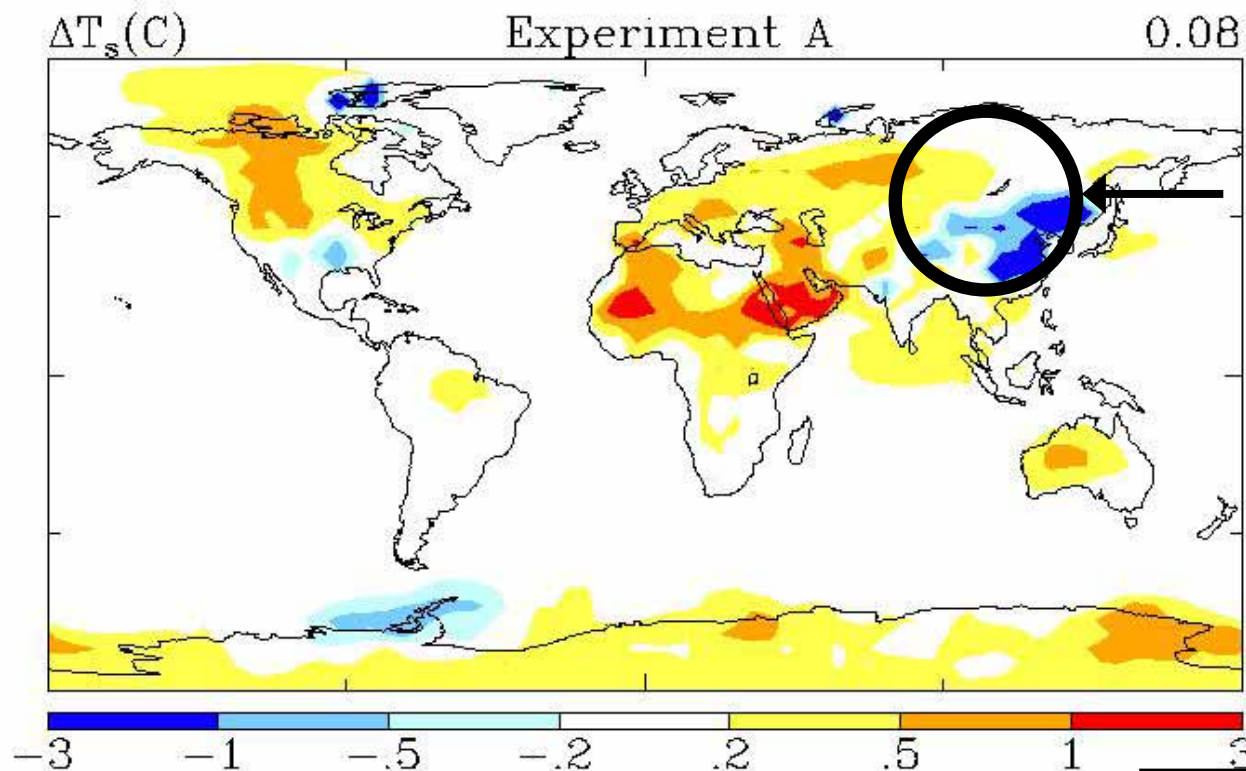
Developmental Coalition for Western China: State-University-Business

- Interior provinces have inherent disadvantage in export-led industrialisation
- Raise agricultural productivity: ecology-specific agricultural research (land grant university system in USA) e.g. dry-land agricultural research for NW, tropical agricultural research for SW
- Modernise service sector for integration into international commerce: software engineering, call centers, accounting centers

Black Carbon from China

- **Fine aerosol < 1 micrometer**
- **Travel in the air for four weeks**
- **One-quarter of global black carbon is from China**
- **Damages lungs, and reduces visibility, damages buildings**
- **Reduces crop yield of up to 20 pct**
- **Modifies local (then global?) climate**

Model-simulated summer changes in temperature



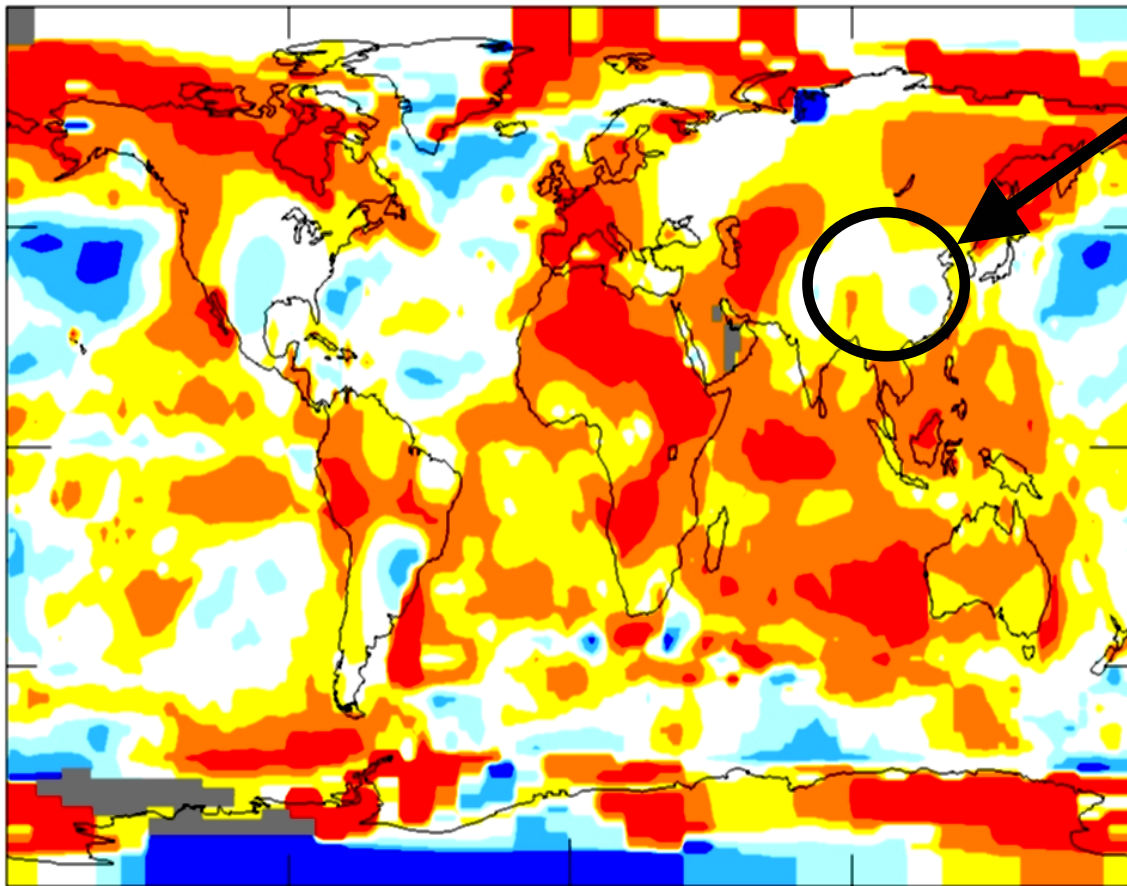
Model suggests a cooling of 0.5 to 1 deg K over China due to reduction in radiation reaching the surface; in other parts of the world, the surface is warmed due to BC heating

From Menon et al., *Science*, 297, 2250-2253, 2002

Observed temperature changes over the past 50 years

Observed ΔT_s (C), 1951-2000

0.40

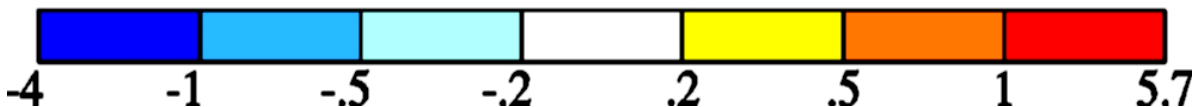


**Negative trend over
China**

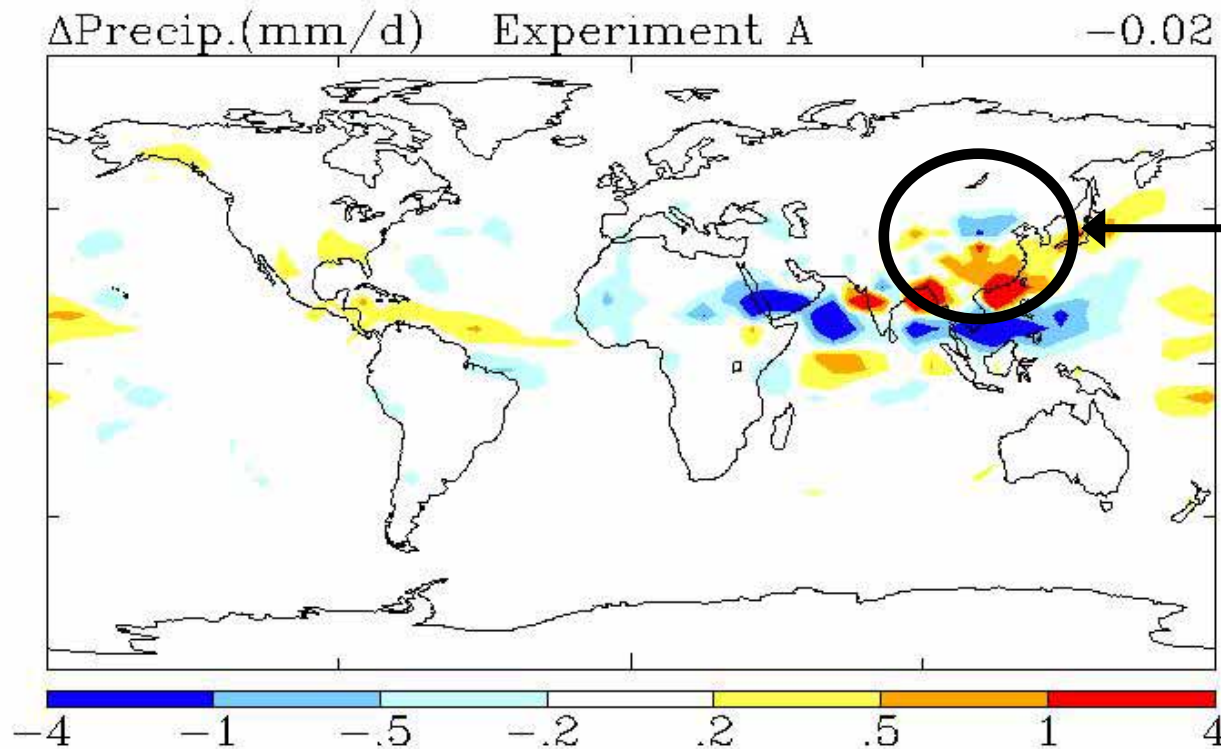
Observed changes in
temperature for the
summer period
between 1951-2000.
Global mean value is
on rhs of graph.

Data available at
<http://www.giss.nasa.gov/data/update/gistemp/maps>

From Menon et al., *Science*,
297, 2250-2253, 2002



Model-simulated summertime changes in precipitation



The model suggests decreased precipitation in northern China (drought) and increased precipitation in southern China (flooding) due to BC aerosols

From Menon et al., *Science*, 297, 2250-2253, 2002

Persistence of NPLs and Gyrations of the Capital- Adequacy Ratio

	<u>1996</u>	<u>1998</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>
<u>Proportion of Non-Performing Loans (NPLs, %)</u>							
Big four banks	40.0	48.0	31.1	26.5	20.4	15.6	10.1
Whole financial system (Ernst & Young, 2006a)				30.2			37.4
Whole financial system (Ernst & Young, 2006b)				30.2			28.2
<u>Average Capital Adequacy Ratio (CAR, %)</u>							
Big four banks	4.4	>8.0	5.0		approx 8.0		>8.0

Should China be Recapitalising the State-Owned Banks (SOBs) Again?

- Capital adequacy ratio (CAR) increased from 4.4 percent at end of 1996 to over 8 percent at end of 1998 upon recapitalisation of SOBs
- Another recapitalisation is being undertaken to enable SOBs to meet BIS standard, and have lower NPL ratios
- Recapitalise to preserve confidence in the SOBs? NO! State can afford out to bail SOBs
- Fan Gang: Recapitalise only when behavior of SOBs is changed.

Postpone? WTO & Foreign Banks

- Cash-flow constraint that a bank (regardless of solvency) must meet in the absence of state subsidies, of operating costs, and of a required reserve requirement is given by:

$$r_D D = r_L [D - \text{NPL}]$$

r_D = deposit rate, r_L = lending rate,

D = amount of deposit

$\text{NPL} = (1/3)D$ and $r_D = 4\%$, then $r_L = 6\%$

- Foreign bank set $r_D = 4.2\%$ and $r_L = 5.8\%$

International Perspective on Public Debt and Public Revenue (percent of GDP)

<u>China</u>	<i>Debt-GDP (%)</i>		<i>Revenue-GDP (%)</i>		
	<u>2001</u>		<u>1995</u>	<u>2001</u>	<u>2007</u>
Official data	16.4		10.7	16.8	21.6
Citigroup (2002)	114.9				
Fan (2003)	74.7				

<i>(as % of GDP)</i>	<i>General govt debt</i>		<i>Total tax revenue</i>	
	<u>1995</u>	<u>2003</u>	<u>1995</u>	<u>2003</u>
Korea	5.5	18.6	19.4	25.3
United Kingdom	52.7	41.9	35.1	35.6
Sweden	82.2	59.8	48.5	50.6
United States	74.2	63.4	27.9	25.6
Germany	55.8	64.6	37.2	35.5
France	62.6	71.7	42.9	43.4
Italy	125.5	121.4	41.2	43.1

Grow out of the Debt?

- No explosive growth of (Debt/GDP) ratio when $y > r$ where
 - y = trend growth rate of real GDP
 - r = real interest rate on government debt
- Steady-state (Debt/GDP) ratio when $y > r$ is:
 $(\text{Debt/GDP})_{\text{steady-state}} = (f+b)/(y-r)$ where
 - f = primary fiscal deficit rate
 - = [state expenditure excluding debt service – state revenue] / GDP
 - b = [increase in NPL in SOBs] / GDP

Equilibrium (Debt/GDP) with SOB Recapitalization

Growth rate, $y = 8\%$, primary fiscal deficit, $f=1\%$,
(recent experience, $f=2\%$), interest rate $=4\%$

(bad loan creation, $b=6\%$ in recent period)

- $(\text{Debt/GDP})_{\text{steady-state}} = 175$ percent when $b = 6$ percent
- $(\text{Debt/GDP})_{\text{steady-state}} = 100$ percent when $b = 3$ percent
- $(\text{Debt/GDP})_{\text{steady-state}} = 50$ percent when $b = 1$ percent

With interest rate $=6\%$ upon interest rate deregulation

- $(\text{Debt/GDP})_{\text{steady-state}} = 350$ percent when $b = 6$ percent
- $(\text{Debt/GDP})_{\text{steady-state}} = 200$ percent when $b = 3$ percent
- $(\text{Debt/GDP})_{\text{steady-state}} = 100$ percent when $b = 1$ percent

*EU requires its members to converge toward Debt/GDP
target of 60 percent*

Progress Report: SCMP, 16 June 2006

Liu Mingkang: "Most banks have not done a good job of reforming their middle and back-office management. In a great number of transactions, the operational risks are enormous ... Inconsistencies in debt repayment procedures are very common in the market. If the risk of default becomes reality, the losses will be huge."

Zhou Xiaochuan: "If we don't place more emphasis on risk controls, it is likely we will have problems and when those problems occur, the pace of reform and experimentation might be greatly slowed down ... The central government will not give another bailout to big state-owned banks that had sold stakes to strategic foreign investors and listed their shares in Hong Kong and the domestic market.,"

What is to be done about the SOBs?

- Diversify bank ownership
 - dismember the Big 4 (e.g. by region a la Ma Bell breakup) into swallow-able pieces for the private sector (strategic investors)
 - license new private banks
- Improve prudential supervision of financial markets
- Keep capital controls in place during transition
- Client Base: SOE performance must be improved, e.g sales of non-traded state shares