

Comments on China's Economic Transition: Supply Side

Papers by GAO Shi-Ji and Louis Kuijs

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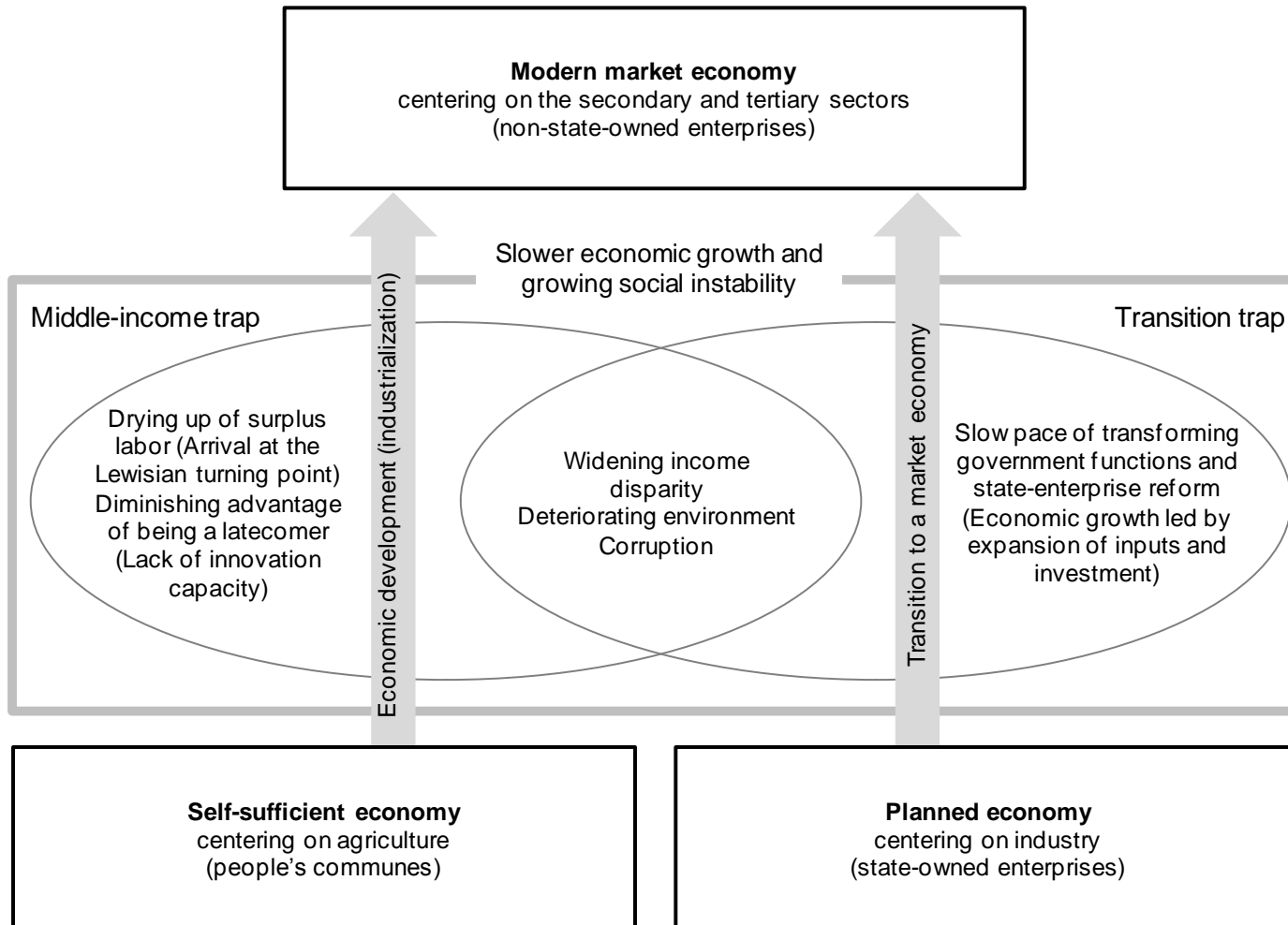


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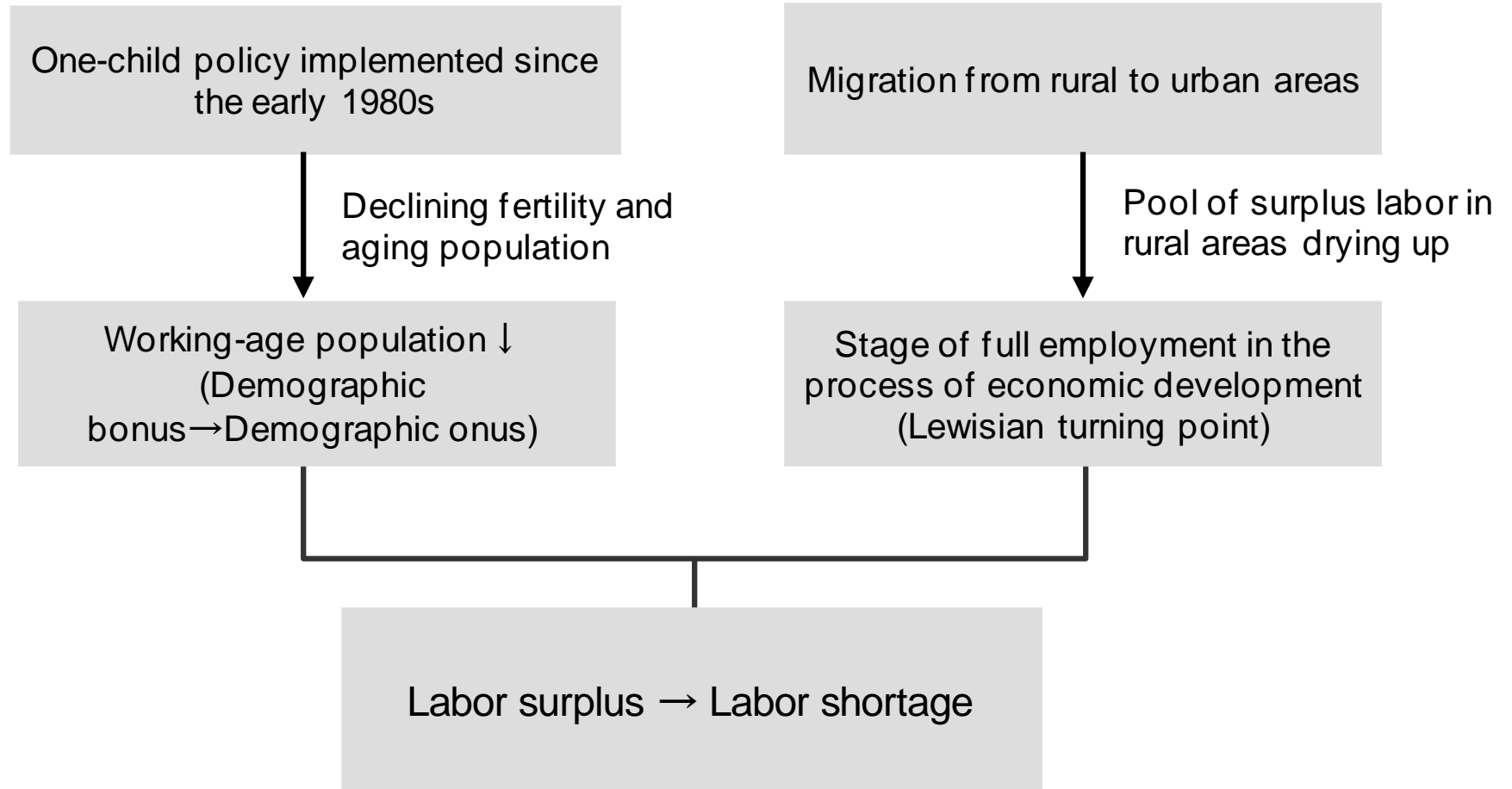
Senior Fellow
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13 November, 2012

- “On Some Reform Measures to Strengthen the Foundations for Future Economic Growth in China,” by GAO Shi-Ji, Development Research Center of the State Council
 - This paper tests empirically the hypothesis that trade volume and investment in R&D and education have a positive impact, while government size and SOEs size have a negative impact on GDP growth in China.
 - To sustain economic growth China needs to further open itself up to the world, invest more in R&D and education, and reduce the size of the government and the state-owned sector.
- “China’s Economic Growth Pattern and Strategy,” by Louis Kuijs, Royal Bank of Scotland
 - This paper emphasizes the need for China to shift from a pattern of economic growth based industry and investment to one based on services and consumption, and to pursue industrial upgrading and move up the value chain.
 - To this end, China needs to improve the allocation of resources, ensuring that they are channeled to new sectors, products and processes, and encourage innovation on one hand, and support migration of peasants to the cities. Reforms in these directions, however, have met opposition by vested interest groups, SOEs in particular.

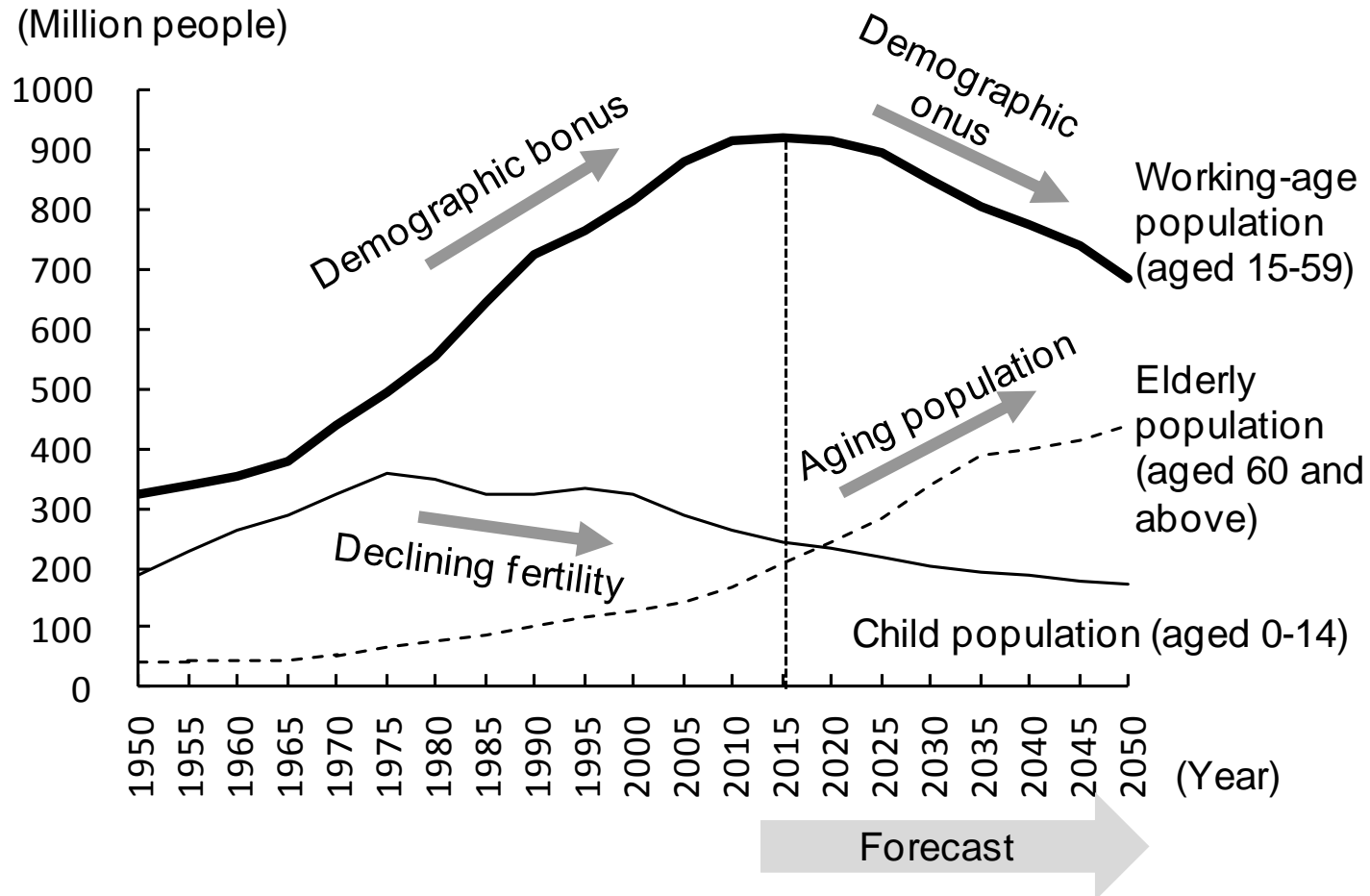


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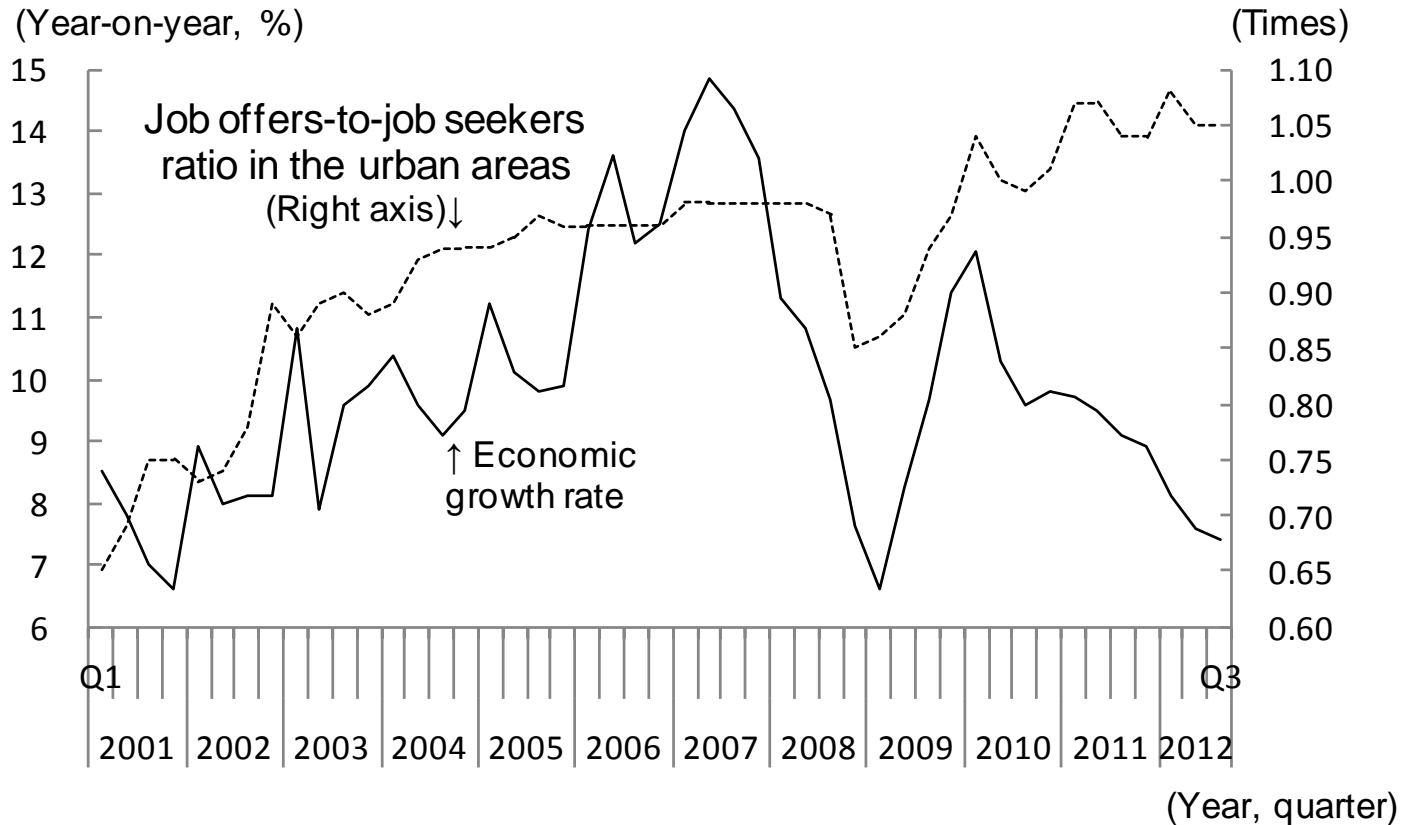
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Changing Age Composition of China's Population



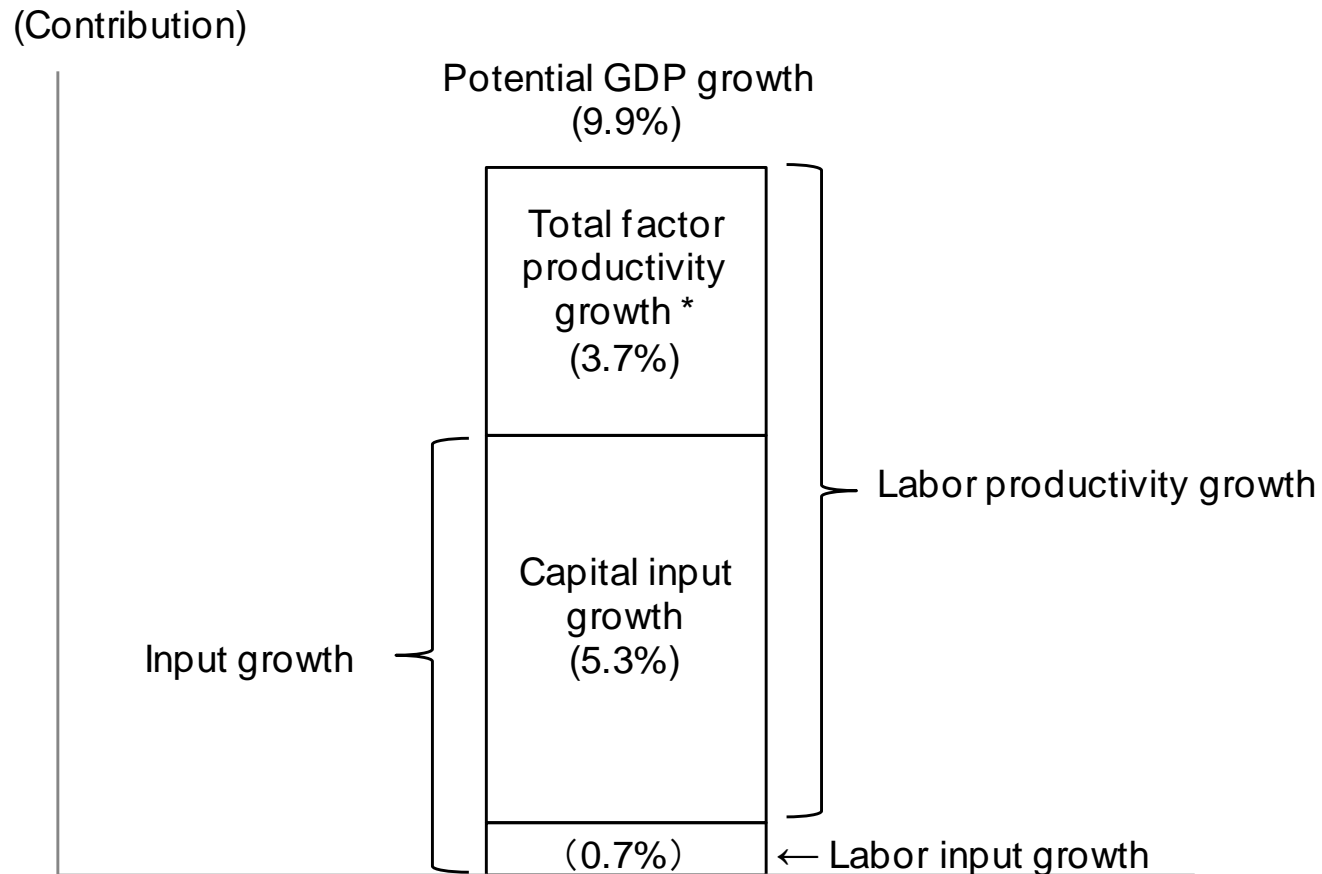
Source: Compiled by Nomura Institute of Capital Markets Research based on United Nations, *World Population prospects: The 2010 Revision*.

Job Offers-to-Job Seekers Ratio Diverging from the Economic Growth Rate



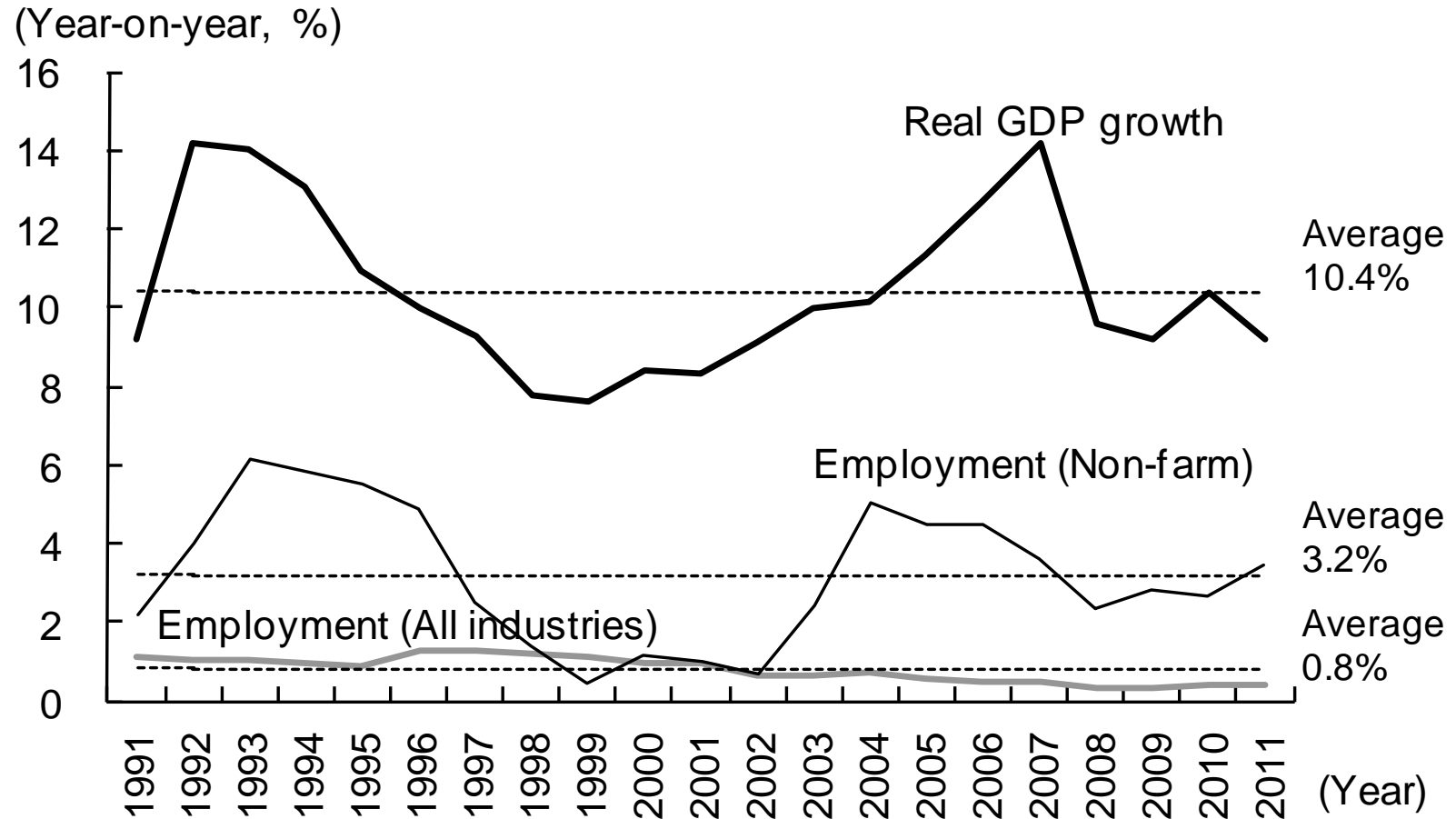
Note: The job offers-to-job seekers ratio in the urban areas of China is calculated by dividing the number of job offers by the number of job applicants registered in public employment service organizations in approximately 100 cities. It is based on “The Analysis on Supply and Demand of Labor Market in Some Cities” published quarterly by the China Labor Market Information Network Monitoring Center, which operates under the Ministry of Human Resources and Social Security.

Sources: Compiled by Nomura Institute of Capital Markets Research based on data from the National Bureau of Statistics of China and the Ministry of Human Resources and Social Security.

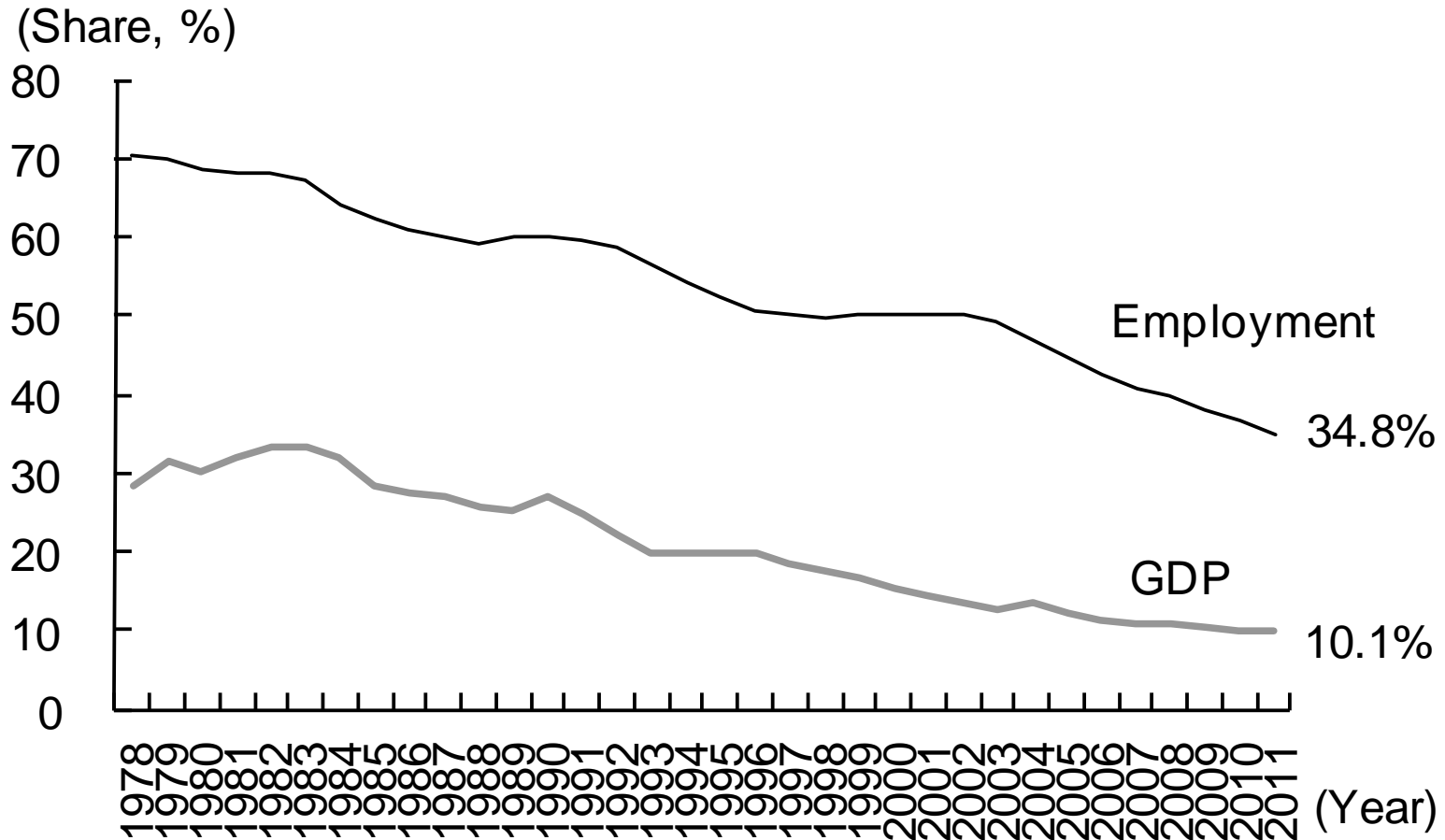


Note: * Total factor productivity growth includes human capital growth.

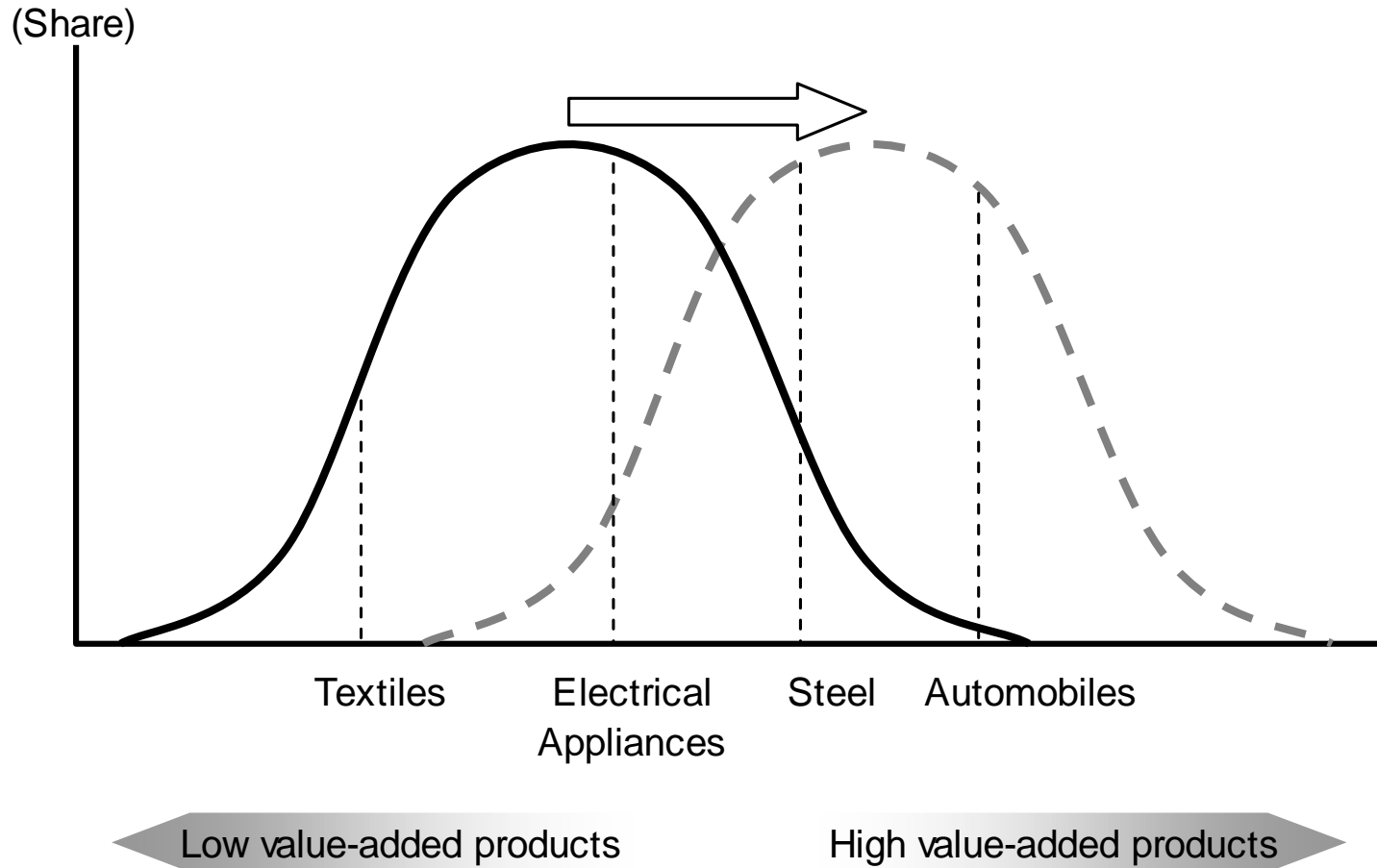
Source: Kuijs, Louis, "China's Economic Growth Pattern and Strategy," Paper prepared for the Nomura Foundation Macro Research Conference on "China's Transition and the Global Economy," November 13, 2012, Tokyo.



Source Compiled by Nomura Institute of Capital Markets Research based on *China Statistical Abstract* 2012.

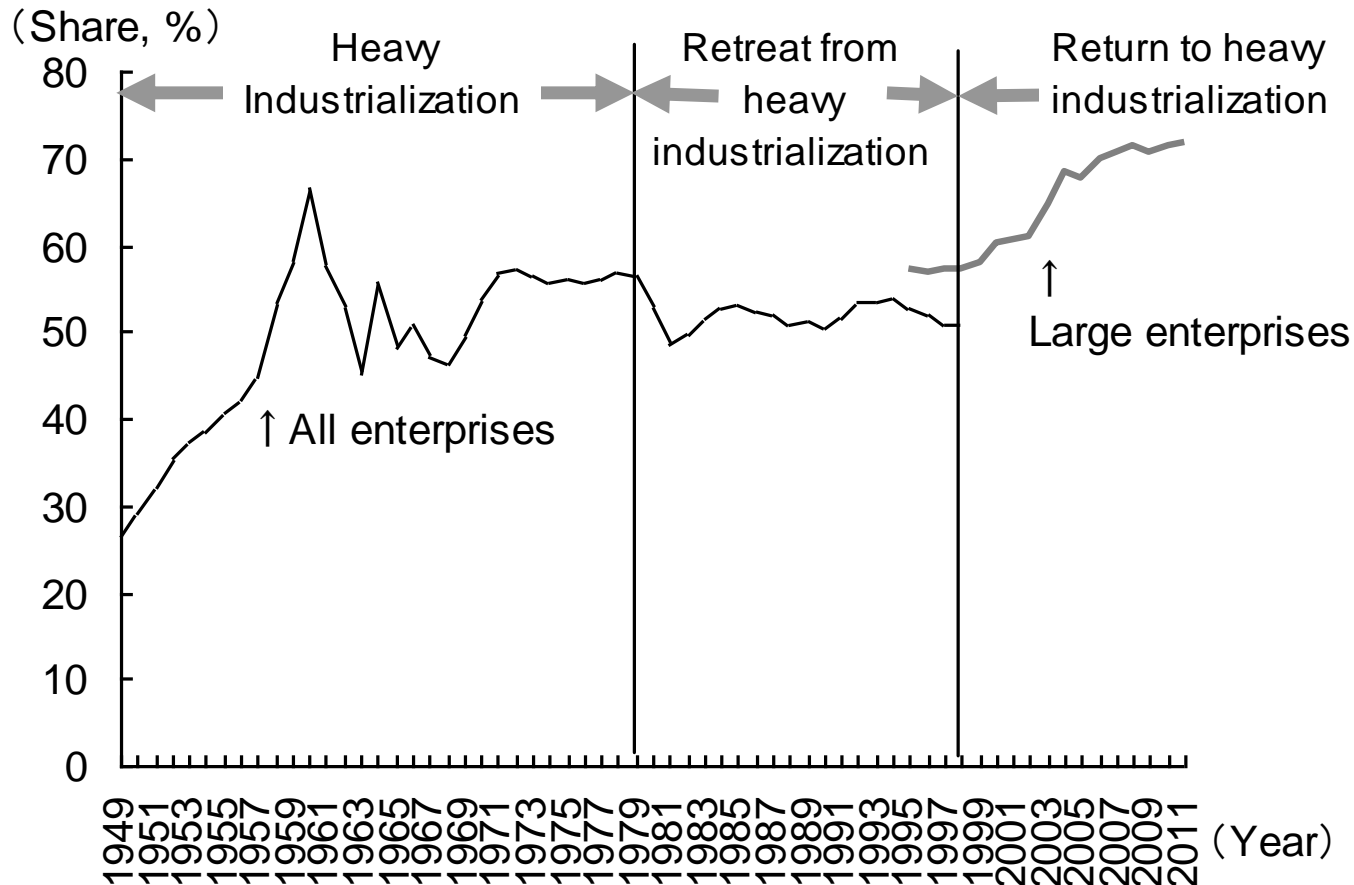


Source: Compiled by Nomura Institute of Capital Markets Research based on *China Statistical Abstract 2012*.



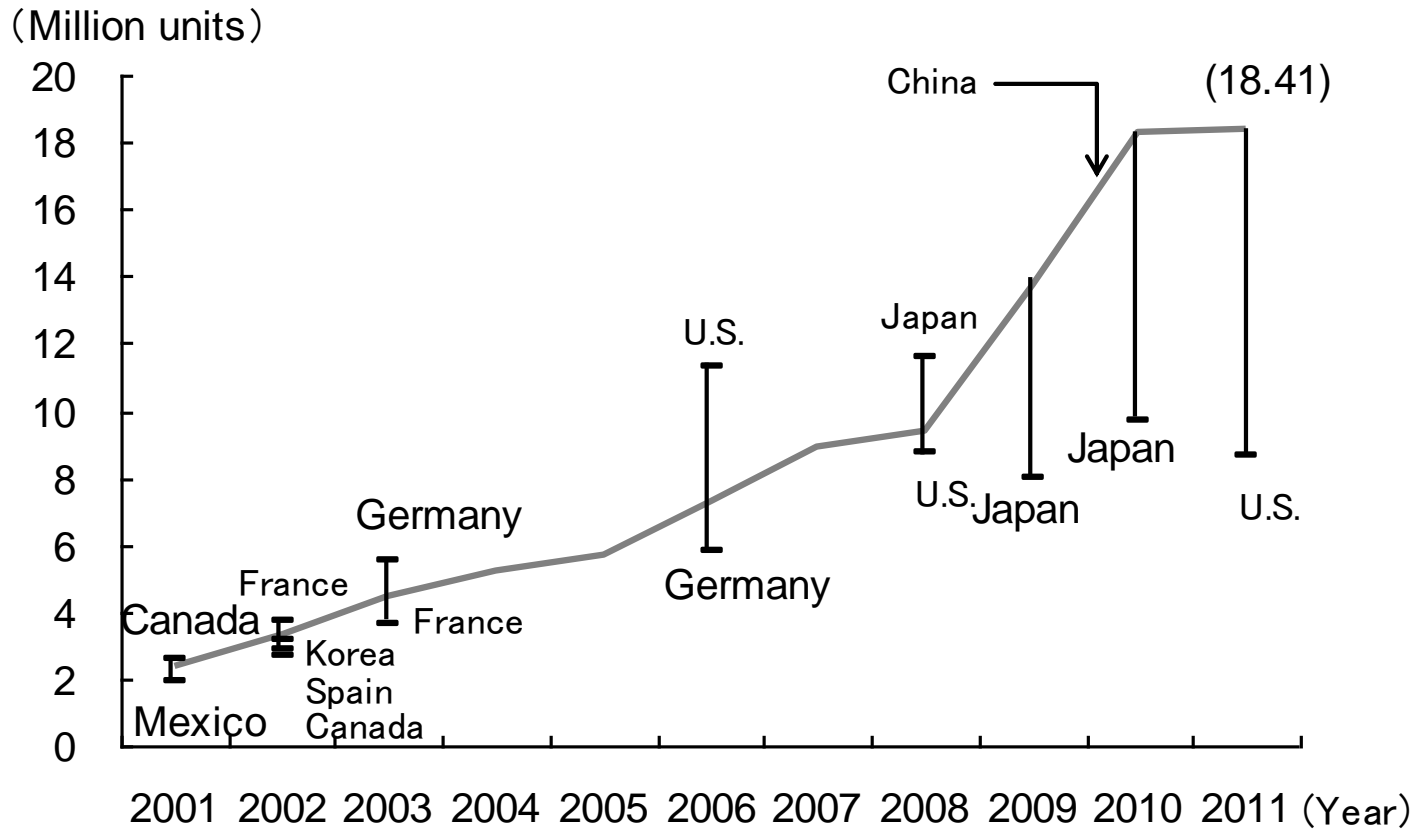
Source: Compiled by Nomura Institute of Capital Markets Research.

Change in Heavy Industry Ratio in China



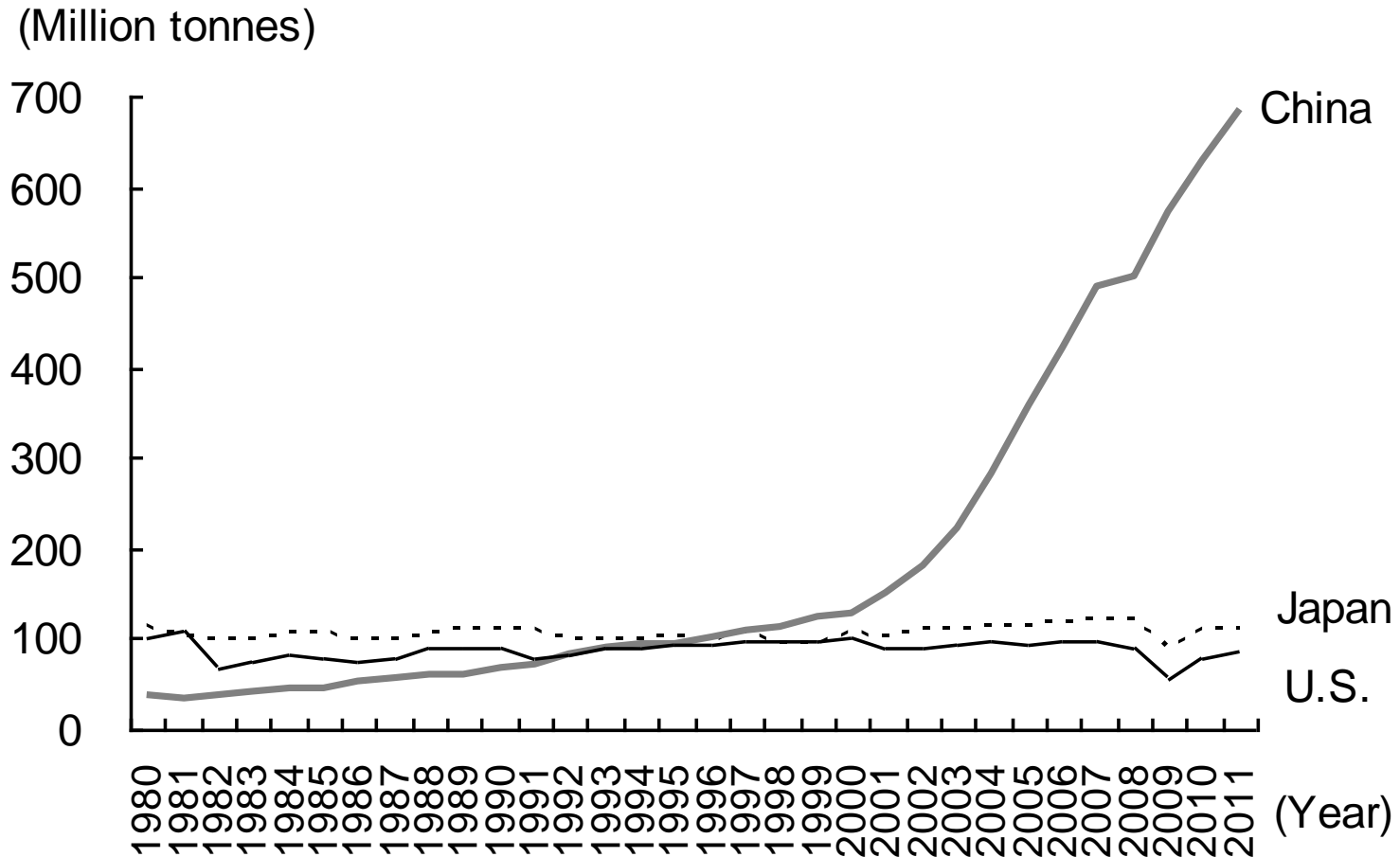
Note: Heavy industry ratio = heavy industrial production / total industrial production. Large enterprises denote enterprises with annual sales of more than 5 million yuan.

Source: Compiled by Nomura Institute of Capital Markets Research based on National Bureau of Statistics of China.



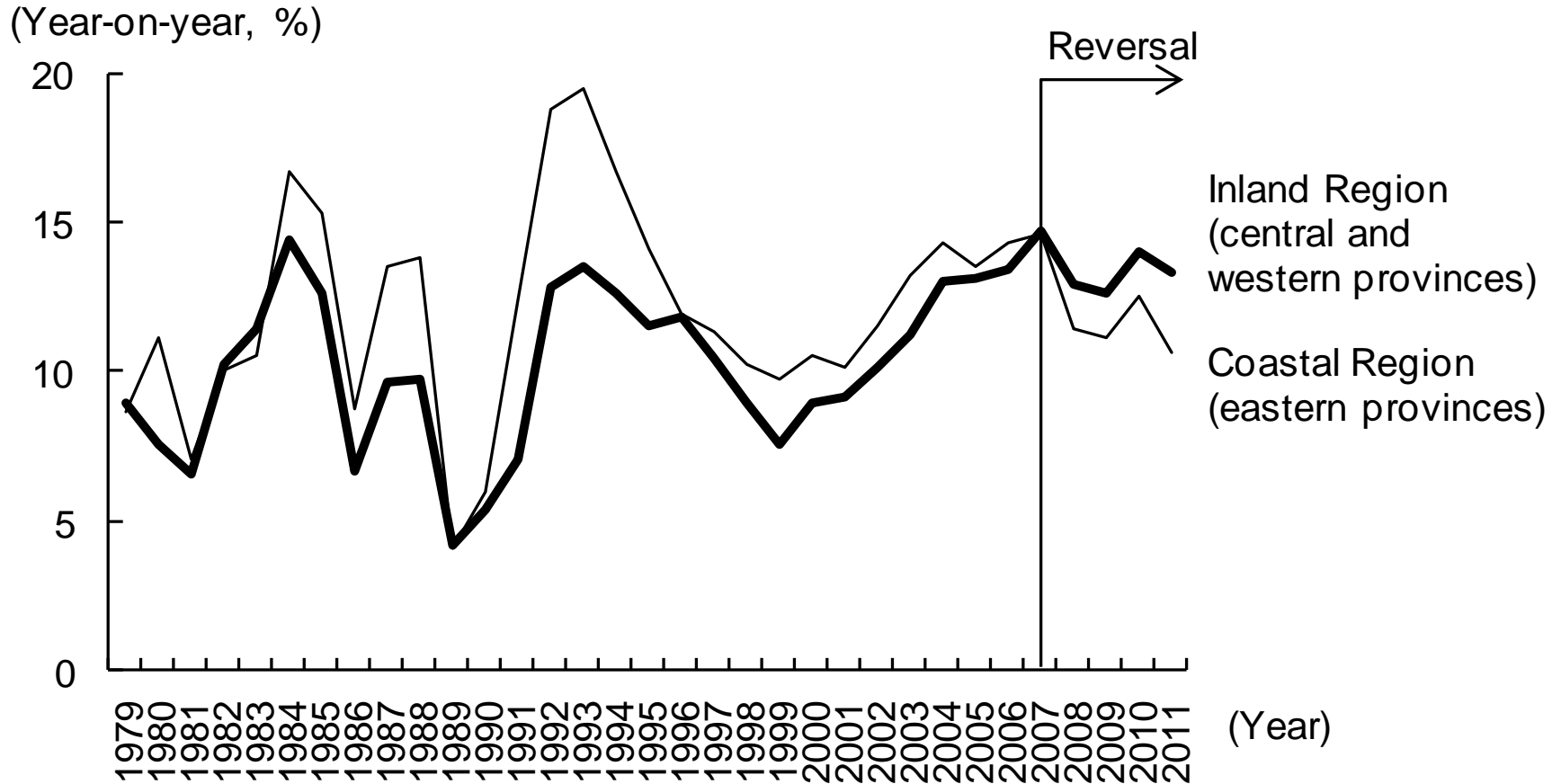
China's ranking ⑧ ⑤ ④ ④ ④ ③ ③ ② ① ① ①

Source: Compiled by Nomura Institute of Capital Markets Research based on *China's Automobile Industry Yearbooks*.



Source: Compiled by Nomura Institute of Capital Markets Research based on World Steel Association.

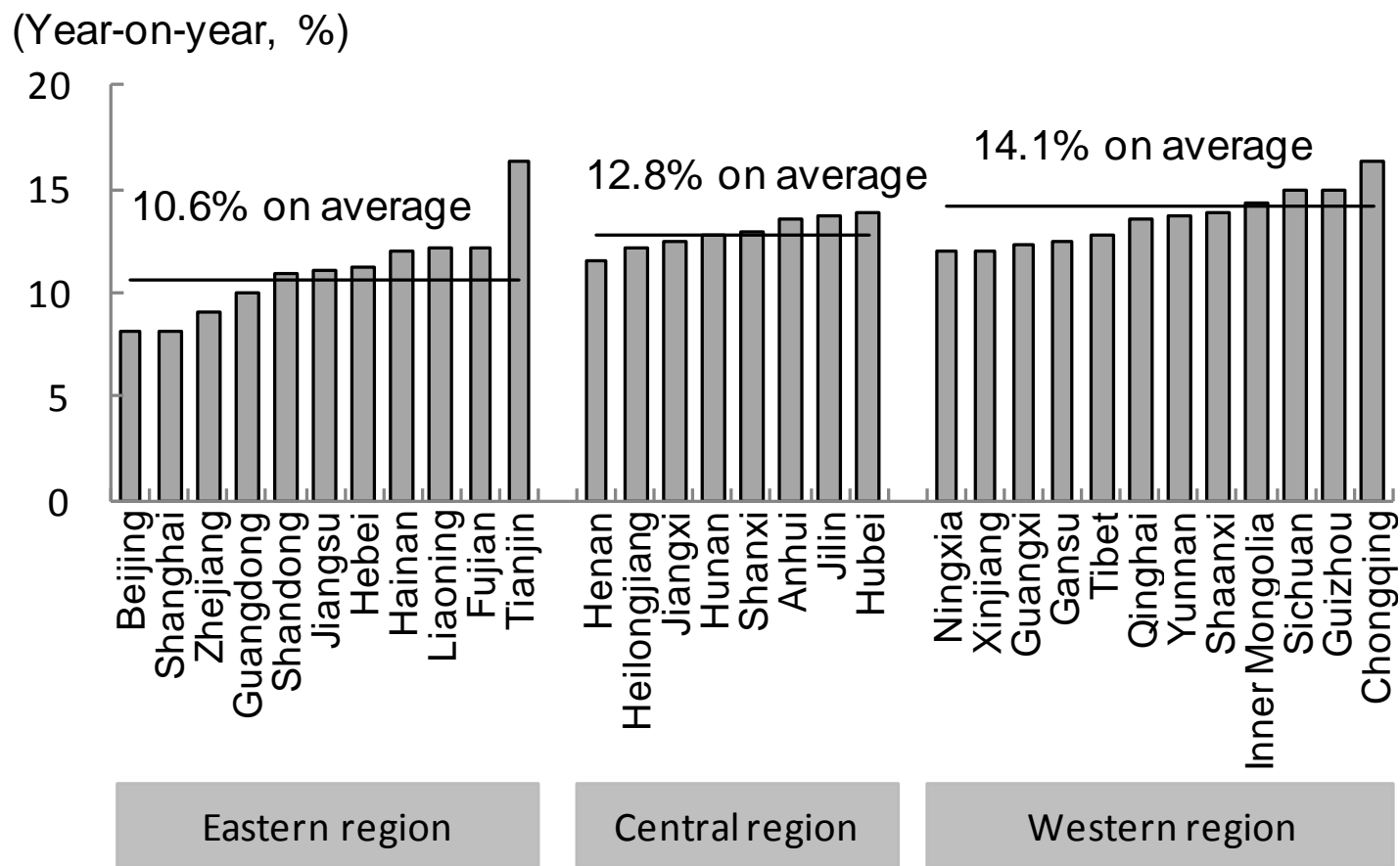
Central and Western Provinces Growing Faster than Eastern Provinces



Note: Weighted average of provincial economic growth rates based on provincial GDP weights in 2011.

Source: Compiled by Nomura Institute of Capital Markets Research based on National Bureau of Statistics of China.

Reversal of Growth Rates between Inland and Coastal Regions (2011)



Note: Weighted average of provincial economic growth rates based on provincial GDP weights in 2011.
 Source: Compiled by Nomura Institute of Capital Markets Research based on National Bureau of Statistics of China.

- Since the late 1970s when China shifted to reform and a policy of opening up to the world, it has sought to transform itself from a planned to a market economy. With administrative reform lagging behind economic reform, however, the government is still intervening in areas where it should not ("overstretching"), while at the same time, it is not playing a role in areas where it properly should ("negligence").
- Examples of overstretching include the facts that the government still controls important resources such as land and that state-owned enterprises continue to monopolize key industries. Also, government officials have considerable discretionary authority and frequently intervene directly in the economic activities of companies. In effect, the government, which should be the referee, is at the same time also a player, so the economic game cannot be fair.
- Examples of governmental negligence, on the other hand, include China's inadequate provision of public goods and services such as environmental protection, social welfare, medical services, and education. Also, economic regulations have not been put fully in place, and their implementation lacks transparency. Moreover, there is a need to develop the market infrastructure supporting financial and other transactions and to strengthen the government's macro control capability.

- The shift of the economic center from inefficient state-owned enterprises to productive non-state-owned enterprises has been driving China's impressive economic growth, but the recent trend of the advancing state-owned sector and the retreating private sector takes it in the opposite direction.
- First, in order to protect their monopoly position, large state-owned enterprises tend to pressure authorities and increase barriers to market entry. This behavior stymies the introduction of competition and the further opening up of markets for non-state-owned enterprises. A typical example of this situation is the concentration of bank lending in state-owned enterprises which makes it difficult for private businesses to obtain financing.
- Moreover, because monopolistic enterprises can easily make profits, they have little incentive to improve efficiency. Consequently, state-owned enterprises remain uncompetitive in international markets. Indeed, despite the fact that China has come to be called the "workshop of the world," the country's major exporters are mostly foreign-affiliated companies. Those Chinese state-owned enterprises that are ranked in Fortune magazine's annual Global 500 scarcely contribute to China's export total.
- In addition, the profits of state-owned enterprises, which are mostly retained internally and not paid out, suppress consumption by reducing labor's share of the national income on one hand, and encouraging wasteful investment on the other.

The Transition Trap Hypothesis

-- As Proposed by Tsinghua University Sociologist Prof. Sun Liping

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- The transition trap facing China
 - The transition trap refers to a situation whereby vested interest groups that emerged in the process of shifting from a planned to a market economy, such as state-owned enterprises, hamper further reform and try to maintain the "mixed system" created during the transitional phase. The consequence is distorted economic and social development and worsening associated problems such as income gaps and environmental destruction.
- Strategy for China to break out of the transition trap
 - China must move into the mainstream of global society based on universal values such as a market economy, democracy, and the rule of law. Rejection of the mainstream is the main reason why China fell into this transition trap, as well as the excuse for vested interest groups to maintain the status quo.
 - China must accelerate political reform. The corruption of power is weakening the government's authority and its ability to execute policies. Political reform has to be embarked upon by creating a mechanism to constrain power, such as increasing the transparency of the government.
 - Instead of delegating the power to make decisions on reforms to local governments and ministries as in the past, the decision-making system has to be changed so that reforms are based on a grand design drawn up at the top level of the central government. When promoting these reforms, the government has to listen to the opinions of the people to gain their support and, at the same time, place a basic value on fairness and justice.