CONTINUING THE CHINESE ECONOMIC MIRACLE

By

Deepak Lal *

China's remarkable economic performance over the last two decades has rightly been hailed as an economic miracle. The sources of this miracle are also well known. The rise in rural incomes with the adoption of the household responsibility system, and the bonus from the demographic transition with a fall in the dependency ratio (the ratio of children and the old to workers), led to a marked rise in savings rates, whilst the creation of the special economic zones in its southern rim fueled unparalleled export led industrial growth through the development of non-state enterprises. This labor-intensive growth allowed the transfer of a vast amount of low wage labor from both the rural sector and the declining state owned enterprise (SOE) sector. This allowed China to grow by 'walking on two legs': by keeping the SOE sector alive whilst the non-state enterprise leg was growing stronger. It thus avoided the loss in output and employment and the attendant social disorder that had characterized other transition economies move from the plan to the market. But this strategy is now running into some serious obstacles which if not tackled could lead to the erosion of the miracle. In this article after briefly outlining these dangers- which will not be a surprise in China- I present a simple way in which China could avoid these dangers by creative use of its large buildup of foreign exchange reserves.

The dangers to the continuation of the Chinese miracle all hinge on the fragility of its financial system. This fragility is in large part due to the continuing direct and indirect subsidization of the SOE sector which is still needed to prevent the unemployment and rescinding of the welfare system currently provided through the SOE's to its past and current employees. But this continuing subsidization of the SOE's to meet the 'social burdens' imposed by the past heavy industry biased planning strategy is leading to serious problems of economic management, inefficiencies in investments and most seriously a threat to a continuation of the high rate of household savings- the fuel of the Chinese economic miracle.

All these problems are linked to the common feature of a capital- intensive heavy industry biased development strategy. This feature, which China shares with India, for example is that implementing this strategy requires financial repression, whereby the government has to monopolize the mobilization and deployment of savings in the economy. Thus in China today nearly 90 per cent of household savings are still held in deposits with the State owned banks; in part because of the lack of alternative savings instruments. Alternatives like stocks in the productive and fast going 'private' non SOE 's are obviously discouraged because this would prevent the deployment of household savings in the SOE's. For most of the deposits in the banks are loaned to the SOEs. Whilst most of the investment in the viable private non SOE sector is either self- financed or else dependent on foreign capital. With few of these growth enterprises being willing or allowed to issue stocks in their companies, the stocks traded on the domestic stock exchanges are mainly those in the SOE's, whose non-transparent accounting practices and perceived unviability deters households from holding much of their savings in their stocks. Hence the thinness and volatility of the domestic stock markets.

This lack of adequate savings vehicles, and the low return households currently get from their savings in the state owned banks, poses a threat to the maintenance of China's high savings rate, particularly when account is taken of the natural depressant of savings with the projected rise in the dependency ratio with the ageing of the population from about 2010. But the state owned banks cannot promote higher savings by raising their deposit rates without a rise in their lending rates to the unviable SOE's whose losses would increase, leading the banks to further increase their loans to cover these losses and thus to a further increase in the non performing loans in the banking system.

These micro-economic difficulties in using the interest rate to stimulate savings and for the efficient sifting and deployment of investments are further compounded by the macro-economic consequences of financial repression. As the interest rate cannot be used as an instrument for managing aggregate demand, heavy handed administrative measures with all their inherent inefficiencies and limited effectiveness (given the self-financed nature of most private (non SOE) investment) are needed to cool the economy. Furthermore, given the fragility of the banking system, fully opening up the capital account of the balance of payments followed by a move to a fully flexible exchange rate system is ruled out as it could lead to a serious financial crisis. I do not think that China's export led growth has depended as many other observers believe on maintaining an undervalued exchange rate. For as most of Chinese manufactured exports are processed goods with little domestic value added, changes in the exchange rate would not markedly effect their profitability. A flexible exchange rate would not therefore hurt China's phenomenal export led growth. This move to a flexible exchange rate is not only needed for a more efficient use of China's national savings but also to fend off the growing pressures for a revaluation of the yuan from both private speculators and China's major trading partners.

Behind all thee prospective dangers currently facing the Chinese economy lie the 'policy' and 'social' burdens' carried by the SOE's because of China's past planned development strategy. The answer must be to eliminate these burdens so that the viable SOE's can prosper in a globally integrated market economy, whilst the unviable one's are allowed to be taken over, or are shut down without causing domestic disorder. Fortunately China's large build up of foreign exchange reserves provides the means to do so.

China's foreign exchange reserves in October stood over $600 billion which in a roughly $1 trillion economy means they are about 60% of Chinese GDP. At the moment they are largely held in the form of US treasuries. Apart from the absurdity of a relatively capital poor developing country making these large unrequited capital transfers to a capital rich country, China must have seen a loss in the real value of these assets. For since its peak in 2002, the US dollar has depreciated by over 30 per cent in trade -weighted terms against the major currencies, while in 2003 the Citigroup US Treasury Index returned a modest 2.3%. Over the last few years, the return on China's foreign exchange reserves (in trade weighted terms) is likely to have been negative.

There is a much better way to deploy these foreign exchange reserves. Only a small part- say $100 billion- are at best needed to fend off any speculative attack on the yuan whilst it remains pegged to the dollar. The rest $500 billion, as well as any future accruals could be put into a Social Reconstruction Fund (SRF) controlled by the Central Bank. This SRF would be run like many public pension funds (eg. that for World Bank (WB) or the University of California (UC) employees to which I belong).These pension funds are overseen by a committee of the institutions who decide the broad sectoral distribution of the fund, and the target rate of return (keeping the value of its capital intact) which they expect the fund's day to day mangers to beat. Thus the UC pension fund which is currently valued at $38 billion is mandated by the Regents of the University to hold 53% US equity, 7 per cent non-US equity, 30% fixed income securities, 5% private equity, and 5% Treasury inflation protected securities (TIPS). In the past twelve months its total return (including capital appreciation) was 22%. The World Bank's pension fund is valued at just over $10 billion, and the asset allocation laid down for it by Bank management is US equities 19%, non-US equities 16%, hedge funds up to 12%, private equity up to 12%, real estate up to 8%, and fixed income securities 40%. In 2003 its return was 18.4%. Over a 10year period the return was about 8%. There is no reason why, if the day to day management is done by a reputable team drawn from around the world accountable to the Bank of China, the SRF should not be able to do as well. This would yield about $40 billion annually from the proposed fund of $500 billion. But, even if we are pessimistic and assume that it only achieves an average long- term return of 5% per annum (whilst keeping capital intact) that should yield at least $25 billion per annum. Thus, the SRF could earn 4 to 2.5 per cent of current Chinese GDP as income each year.

This annual income from the SRF should initially be used to retire the existing 'social' burdens carried by the SOE's. They could then be treated as normal commercial enterprises which could be privatized if viable and closed down if not. This would end the subsidies from the banking system which have led to its fragility, allow transparent accounting of SOE stocks traded on the stock market, allow the banks to perform their primary intermediating function of efficiently mobilizing domestic savings and transferring them to high yielding investment projects, and with the restoration of health to the financial system allow China to float the yuan. In time, as the SOE problem disappears, the income from the SRF could become the basis for a fully funded pensions system for its increasingly aging population . The SRF thus provides a means for China to move fully from the plan to the market by removing the sources of fragility in its financial system, whilst removing any danger of social disorder from the rescinding of the current 'social' burdens borne by the SOE's or from the future need to provide pensions for an ageing population.

* The author is James S. Coleman Professor of International Development Studies, at the University of California at Los Angeles. This article is based on a visit to China in October when he was visiting the Center for Chinese Economic Research at Peking University, and the Dept. Of Economics at Fudan University.