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Special Edition

# The Five-year Outlook for China's Economy

## - Interview with Zhong Wei (Professor and director of the Finance Study Center of Beijing Normal University) -

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# Interview with Zhong Wei (Professor and director of the Finance Study Center of Beijing Normal University)

The relative importance of the Chinese economy and currency has increased further in the wake of the global financial crisis. China's twelfth five-year plan (2011–15) seeks to accelerate the transition in the nation's economic development model, which has long been an issue of concern. Moves to establish the RMB as a global currency have also picked up over the last two years. What kinds of changes can we expect in the Chinese economy going forward, and how powerful is it really? We spoke with Zhong Wei, who serves as director of the influential Finance Study Center of Beijing Normal University and is a leading macroeconomic and monetary policy researcher.

Zhong Wei

Professor and director of the Finance Study Center of Beijing Normal University and professor of finance at Xiamen University

Born in 1969, Zhong Wei is an expert on the RMB exchange rate and on structural issues in the Chinese banking sector. His books include *Research on the Global Transmission Mechanisms of Inflation*, *An Overview of Financial and Capital Globalization Theory*, and *Post-Crisis Trends in Global Monetary and Supervisory Policy*. He conducts policy research and consulting for such institutions as the Asian Development Bank, China's Ministry of Finance and the People's Bank of China. He is also deputy editor of *China Foreign Exchange*, published by the State Administration of Foreign Exchange.

Takeshi Jingu

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Takeshi Jingu joined NRI in 1983 and completed his MBA at UCLA Anderson School of Management in 1988. He took on his current position in August 2010 after stints at what became NRI America; the Economic Research Department's Economic Research section where he served as director; the organization that is now NRI Hong Kong; the Beijing office of Nomura Securities; and the Beijing office of Nomura Institute of Capital Markets Research, which he headed. His research covers the macroeconomy and the financial sector, and his books include the jointly authored *All About Chinese Securities Markets*.

# Interview with Zhong Wei (Professor and director of the Finance Study Center of Beijing Normal University)

## Recent economic conditions

**Jingu**
Today I would like to ask you about the long-term outlook for Chinese economic growth. Could we begin with your views on the current state of the Chinese economy?

**Zhong**
Real growth in the first half of 2011 was 9.6% on a year-over-year basis, exceeding predictions that it would be no more than 9.5%. Such high growth is unacceptable given how restrictive economic policy is and will probably lead to further tightening in the second half. In particular, I expect tougher structural adjustments in the form of controls over energy consumption and emissions.

**Jingu**
Some are predicting an easing of policy in the second half.

**Zhong**
That is unlikely to happen. I forecast 9.0–9.2% growth in the second half and 9.4% for the full year, which is still high.

I would like to briefly analyze the problems facing Chinese economic growth. I have proposed a concept called the “impossible trinity,” where the trinity consists of fast economic growth; efficient, high-quality economic growth; and stable inflation. The trinity is impossible because the Chinese government can only achieve two of these three goals. If it wants a stable inflation rate and efficient, high-quality growth, it will have to partially sacrifice the speed of growth. But the government does not appear ready to sacrifice economic growth.

An examination of economic growth in the first half and the outlook for the full year suggest a negligible probability of a hard landing for China. In the first half, China remained the world's fastest-growing economy, while inflation was stable relative to conditions in other countries. From a global perspective, therefore, the Chinese economy is currently experiencing a period of high growth and low or at least stable inflation. I see almost no risk of a hard landing between 2011 and 2012.

Turning to inflation, the CPI rose 5.5% year-over-year in the first half. Factors contributing to inflation can be divided into previous-year base effects and new inflationary factors operative in the current year. Each type is able to explain about half the 5.5% inflation rate in the first half. New price increases are due almost entirely to the rising cost of food and housing rent. China's core inflation rate is not particularly high, and I expect it to remain around 4% for the next three to four years.

I forecast that Chinese economic growth will be somewhat high but stable in the second half of 2011 and 2012, and inflation should also be manageable. In short, there are no problems with the pace of economic growth. But I think the prospects for industrial structure reforms are bleak.

## Is there a real estate bubble?

**Jingu**
How about real estate? Some people seem to believe that the market is already in a bubble.

**Zhong**
First, we need to remember that the real estate price data published by the Statistics Bureau are for the 70 large urban areas where prices are the highest. They do not include the more than 300 smaller cities or the more than 2,000 counties. The ratio of housing prices to incomes in those 70 urban areas typically ranges from 17x to 20x, or about twice what would be considered a reasonable level (under 10x).

Second, the construction of subsidized housing for people in the low and middle income brackets has a substantial influence on commercial house prices. The Chinese government's plans to build 36mn units of such housing over the next five years will place substantial pressure on the price of commercial housing. More importantly, subsidized housing is provided by local governments and therefore has a major impact on local government finances.

Third, while Chinese property prices are clearly high, I do not expect them to collapse within the next five years for several reasons.

The first reason is the speed with which the money supply is increasing. Chinese M2 continues to grow at a double-digit pace, doubling every four or five years. At the root of the increase in property prices is monetary policy. And for now it is difficult to envision a slowdown in money printing.

The second reason is the still-low percentage of China's population that lives in urban areas. This figure stood at 46% at the end of 2010 and is expected to rise to 55–58% by 2020. In addition, the number of housing units per household currently stands at 0.92–0.94, signifying a shortage of housing in the aggregate. The growing population and the continued migration of people to the cities have combined to create a need for more housing.

The third reason is that Chinese investors have few normal, reasonable investment vehicles open to them. In effect, there are no normal channels for the investment of the private sector's large net savings. Yields on Chinese government debt and bank savings accounts are both low, with real interest rates in negative territory. And over the past three to four years China's stock market has been one of the worst performers in the world. This absence of normal investment channels forces China's private investors to turn to the real estate market.

It is because of these factors that Chinese real estate prices are too high and are in fact in a bubble. But the bubble is robust enough that it is unlikely to burst over the next five to eight years. Given the rapid financial deepening observed in China, real estate prices in Beijing and Shanghai could rise to, or even exceed, the levels of Tokyo and London.

## The Chinese economy during the twelfth 5-year plan

**Jingu**
Next I would like to ask about the longer-term economic outlook. A primary objective of the twelfth 5-year plan is an accelerated transition in the nation's approach to economic development. I am particularly interested in the engines of growth: exports, fixed asset investment, and consumer spending. How will this transition be achieved?

**Zhong**
The approach to economic development is not all that must be transformed during the twelfth 5-year plan. China also needs to transform its political system, society, and economy. This is both an opportunity and a challenge.

The Chinese government is considering a number of approaches to transforming the economic development model. One is the promotion of new industries, and in particular new energy, high-tech facilities, next-generation internet technologies, bioengineering, and electric vehicles. By 2020 the government hopes to lift these sectors' share of GDP to 8% in 2015 and to 15% in 2020.

Another approach concerns income distribution. China may raise the minimum wage by 10% or more during each year of the twelfth 5-year plan. The price of labor is likely to double over the next five years, making it a more expensive production factor.

A third approach concerns the sea. The Chinese government places a great deal of emphasis on marine resources in general and deepwater petroleum in particular. The coastline of southeast China may change substantially as land is reclaimed, and marine pollution may worsen.

Next I would like to focus on the three engines of economic growth: consumption, investment, and foreign trade.

I estimate that consumption's contribution to growth will not increase markedly and, at best, will remain roughly where it is. Individuals' income now accounts for 40% of GDP. Farmers' disposable income is growing by just under 10% a year and has increased by 7–8% a year in the 30 years since the introduction of China's open-door reforms. Meanwhile, urban residents' income is growing

at an annual rate of 11–12%. Leaving aside the question of whether this kind of distribution is fair or not, consumption should not increase by any more than incomes.

The income distribution in China has recently been characterized by growing shares of government and business in the primary distribution, while individuals' share has diminished substantially. This indicates that consumption will grow modestly over the next five years, rising by 10–12% a year in real terms, or roughly as fast as incomes. Accordingly, I estimate that consumption will contribute about 5ppt to China's economic growth during this period.

Turning next to investment, fixed asset investment has increased by about 18% a year over the last 30 years and by more than 20% a year over the last decade. Will the most important component of future Chinese growth be investment or something else? External trade cannot be expected to make a substantial contribution as the cost of labor rises and the pace of technological innovation is slow, and we have already covered consumption. Therefore, I think Chinese economic growth will continue to rely most heavily on investment, and particularly investment by the government and the state-owned economic sector. I project that fixed asset investment will continue to grow by about 20% a year over the next three to five years, providing a 3.5ppt contribution to GDP growth.

As for external trade, foreign trade (total exports and imports) grew at an average annual rate of 10% in the 1980s, 15% in the 1990s, 20% over the last decade, and 25% (annualized) over the last six months. I anticipate annual growth of 15–20% over the next five years and net exports will contribute –0.5ppt to GDP growth.

**Jingu**

Will the structure of economic growth stay the same?

**Zhong**

Mostly. The real changes will be driven by the constraints imposed by resources, population, and the environment.

As I noted earlier, the Chinese economy should be able to maintain growth of at least 8% over the next five years on consumption and investment alone, barring major problems. For the Chinese government it is easy enough to maintain 8% growth, and that is why there has been only gradual progress in the structural transformation of the Chinese economy.

**Jingu**

Wouldn't a growth rate of 8% create problems in terms of employment?

**Zhong**

No. Although the government is under constant pressure to create jobs, that pressure is steadily diminishing. The Chinese labor force will peak at 585mn people in 2015 and then start to decline. By 2020 China's elderly population will have doubled from current levels. People aged 60 and older may account for more than 20% of the total population, while those under the age of 15 will account for less than 15% of the total. The aging of the population will be a very serious issue for China in 2020.

**Jingu**

What effect will that have on businesses? As labor costs rise, will companies have to think about ways to raise their production efficiency?

**Zhong**

Yes. However, an increase in production efficiency must imply the pursuit of further technological innovation. Although year-over-year growth in industrial output recovered to the 15% level in the first half, energy consumer per unit of manufacturing output is increasing. The biggest issue facing Chinese companies is neither raw material costs nor the labor supply nor costs but rather the ability to innovate. Japan is ranked second in the world in terms of patents and inventions per person, and Korea is ranked fifth, but China is far down the list. Businesses cannot survive for long if they are not strong innovators. China has many large companies but few strong, capable companies. This is the biggest problem. Issues such as branding and sales channels are not as important as the ability to innovate.

My long-standing view regarding Chinese economic growth is as follows. I am optimistic on the outlook for short-term problems because the country has accumulated a great deal of wealth and experience in the 30 years since the open-door reforms were introduced. But at the same time I have a pessimistic view of the longer-term problems facing the economy. China still has many issues that must be addressed. There is a mystery at the heart of the framework for Chinese economic growth, and although this mystery has worked well enough until now, no one knows how long it will remain effective.

We must not overestimate China's economic growth potential. At present, the combined GDP of China and India is some $7trn, or roughly one-fifth the combined output of Europe, Japan, and the US. Yet these two Asian nations have 2.5bn people, more than three times the combined populations of the other three. I simply cannot envision per capita GDP in China and India reaching the levels of the west.

Long-term forecasts indicate that Chinese GDP will rise to $20trn in 2020. Some 70% of this will come from economic growth and the remaining 30% from appreciation of the RMB. Barring any major problems, China's economy should surpass the US sometime between 2020 and 2025. When China catches up with the US, both will have GDP of about $25trn. Although China is likely to become the world's largest economic unit within ten to fifteen years, per capita GDP will only be about 40% of current levels in the developed world. That marks the extent of China's growth potential. And it may not reach that level.

Even if China eventually becomes the world's largest economy, its large population, lack of natural resources, and deteriorating environment will ensure that it is only a large country, not a strong country. While China may acquire the status of a regional power, it will not become a global power. Chinese culture is not something that can be transmitted to all the countries of the world. And given the limits to the nation's potential for per capita economic strength, China will simply not have the power needed to change the global political, social, military, or economic environments.

## Capital liberalization and the RMB

**Jingu**
Finally, I would like to hear your thoughts regarding capital account liberalization, the RMB exchange rate, and the globalization of the RMB.

**Zhong**
At present there is no timetable for the liberalization of the capital and financial accounts. In my opinion, the Chinese government will not have the confidence or the resolve needed to scrap restrictions on the capital account within the next ten years. Relaxing those rules would be risky at a time of pressure from the strong RMB. And the US, Europe, and IMF have indicated a greater tolerance for capital account restrictions since the subprime crisis. It appears as though the Chinese government will take advantage of this climate to leave its capital account restrictions in place. As such, I do not expect meaningful relaxation of capital controls over the next decade.

As for the RMB exchange rate, there are two issues I am concerned about.

One is that the Chinese government has already missed its best opportunity to engage in currency reforms. Widening the trading band for the RMB and liberalizing foreign exchange both have the same impact: an accelerated appreciation of the RMB. But that is what the Chinese government does not want. The best time to carry out currency reforms would have been from 1994 to 2005.

At the time, the Chinese government had the leeway to push ahead with reforms. Its balance of international payments and foreign reserves were still relatively small, and it would have been comparatively easy for companies engaged in foreign trade to make the necessary adjustments. Now, however, it would be extremely difficult to do so.

I also worry that the RMB will suffer the same fate as the Japanese yen—in other words, that the government's refusal to revalue the currency will turn to a gradual appreciation of the currency and then give way eventually to a rapid rise, sparking a variety of problems. In 2005, when the US dollar bought approximately RMB8.3, the US Congress demanded that the Chinese government revalue its currency by 22%. Although today's rate is 6.4, which represents more than a 22% increase from that point, the US is still not satisfied and is seeking further appreciation. I suspect they would not be happy even if the Chinese currency were trading at a nominal rate of less than 5 to the dollar in 2015.

**Jingu**

Japan has had similar experiences. What is your view on the globalization of the RMB?

**Zhong**

The globalization of the RMB faces a raft of obstacles, the first of which is capital liberalization. As I noted earlier, it is not possible to open up the capital account in a short period of time. But how can you persuade foreign governments and banks to hold and use the currency without liberalizing the capital account?

Second, the route by which the RMB will be globalized has yet to be decided. There are two possible routes: offshore and onshore. The former would involve mainly the globalization of non-resident operations in places like Hong Kong and Singapore. The latter would focus on resident operations in Beijing and Shanghai. Attempting to achieve the globalization of the RMB via trade settlement channels and offshore channels may not be realistic.

Third, trust is essential. Two things will attract foreign governments and businesses. One is further foreign direct investment. However, there has been relatively little foreign direct investment by Chinese companies outside of Africa. Here I think China is making a potentially critical mistake. Instead of engaging in foreign direct investment, we are using our massive savings to buy sovereign debt. A Chinese purchase of $10,000 in Treasury securities will not be appreciated by Americans, nor will it have any impact on US firms. But if the Chinese government were to invest directly in the United States and buy the equity of US companies, US companies might show more interest in Chinese enterprises.

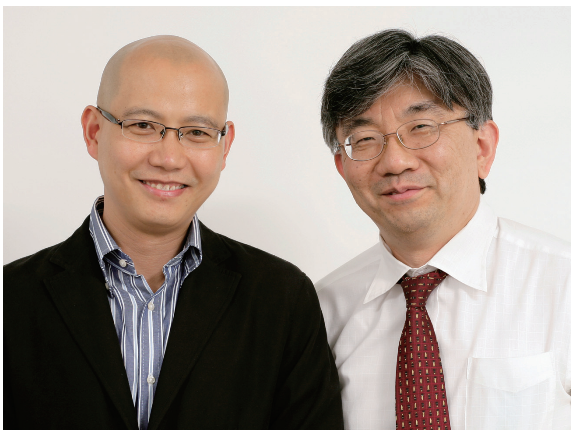
Another thing that will attract foreign governments and businesses is the opening of Chinese markets. China is currently running a trade deficit with (ie supplying demand to) Japan, Taiwan, and ASEAN, and the government has little tolerance for running deficits with other trading partners.

At the moment China is neither engaging in direct investment nor providing a market for its trading partners' goods and services. Under such circumstances there is no reason why the globalization of the RMB should be possible. Without Chinese investment or markets, the question of whether the RMB is a good currency or not is largely irrelevant to foreign governments and companies.

Japan had a similar opportunity to push ahead with the globalization of the yen between 1985 and 1994, but it did not take advantage of it. China may waste its own opportunity.

We have no clear ideas or map for the globalization of the RMB. Efforts thus far can be summarized as follows. First is the Chiang Mai Initiative, which although important in its own right had little impact on the globalization of the RMB.

Second is the RMB-denominated settlement of trade and direct investment. The problem with this is that it involves the People's Bank of China and non-residents and does not incorporate the broader private sector. Few will get excited about a program offering only a relationship with China's central bank and not with its commercial banks.



Third is the establishment of a global financial center. The Chinese government has long wavered between Shanghai and Hong Kong on this score, and both cities' efforts to promote a global RMB have been limited.

That is all we have done so far. Accordingly, I do not think the prospects for the globalization of the RMB are any better than they were for the yen. Although the Chinese economy will eventually grow to become much larger than that of Japan, it is making many of the same mistakes.



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