New sources of China's economic growth

Ligang Song
The Australian National University

Against the background of the Asian financial crisis and the widespread slowdown projected for the region, China's economic performance has become the focus of many observing the regional economy. The main purpose of this paper is to discuss some policy issues surrounding the growth targets and performance of the Chinese economy in 1998 and beyond.

Importance of maintaining a relatively high growth rate

China needs to maintain a relatively high economic growth in its transition towards a market economy. A robust economic growth rate will provide

- a constantly rising standard of living to most of the Chinese people which is imperative for maintaining popular support for the reform and liberalisation program
- opportunities of reemploying a large number of laid-off workers resulting from large-scale reform of the state-owned enterprises (SOEs) which is significant for maintaining the social stability in the transition period
- opportunities to absorb a large number of surplus rural labour released as a result of agricultural reform which has boosted production efficiency and changed the management of labour
- favourable conditions for carrying out structural changes in the economy (the irrational economic structure is generally regarded as a big hindrance to economic efficiency and performance)
- sources of income necessary to support reform programs by different levels of government which enlarges their fiscal means and capacities
- a favourable environment to attract inflows of capital especially foreign direct investments which in turn contributes substantially to the economic growth and performance especially the external sector
- a buffer to the economy to overcome external shocks (such as the current financial and economic crisis in East Asia) which weaken demand for exports
- some hope for helping the Asian economy get out of the current crisis quickly or preventing it from getting worse by maintaining import levels from the troubled economies.
In short, a robust economic growth of the Chinese economy not only creates a favourable environment for a smooth economic and political transformation in China, but also have significant implications for the recovery of the East Asian economy from the current financial and economic crisis.
Difficulties in achieving the growth target

While there is no general consensus about the minimum level of growth at which the society can withstand the impact of the reform program, past experience, especially from the 1980s, implies that maintaining a growth rate of at least six percent per annum would be necessary for a smooth restructuring of the economic system.

This is perhaps the main reason for the government to set a growth target of eight per cent per annum towards the end of 1990s and seven per cent in the first decade of the next century. The government has set a growth target of 8 per cent for 1998.

However, achieving this growth target has been overshadowed by some of the recent developments both in and outside China. They include:

- weak market demand characterised by the slow growth of the retail sales
- a steady build-up of inventories
- negative growth in prices indicating clearly that deflationary pressures have been mounting in the economy since October 1997 (retail prices fell 3 per cent in June 1998 after a 1.9 per cent drop in the first five months of the year).

A related question is, with a large amount of domestic savings, why don't people consume? There are three reasons.

1. There is a gap in household consumption patterns. For example, the markets for general consumer durables, such as colour televisions, refrigerators and washing machines, have been satiated and more expensive items such as automobiles and housing are still beyond the affordability of the general households.

2. Such gap could be filled by rural households' consumption of those goods at the lower end of the consumption patterns, but rural consumption has also been weak due to relatively slow growth of rural income in recent years.

3. There are uncertainties among urban workers about the future due to reforms of SOEs, pensions, medicare, housing and education.

Thus it remains a difficult task for the government to mobilise domestic savings to productive uses in a bid to bolster domestic demand and reach growth of 8 per cent in 1998 and beyond.

- Declining profit earnings by SOEs and under-utilisation of their production capacities indicates a general lack of investment opportunities in the economy and an urgent need to overhaul the SOEs.
- High real interest rates due to low inflation imposes heavy financial burdens on enterprises especially SOEs and hinder investments.
Over supply of both consumer and producer goods indicates a shift from a sellers' market to buyers' market which means markets are more competitive and require further improvements in product upgrading and management by domestic firms. Industrial growth continued to be sluggish in the first half of 1998 and township and village enterprises were particularly hard-hit by the shift in market patterns;

External trade and capital inflows slowed down due to the shrinking Asian markets and devalued currencies of turmoil-hit countries, greatly affecting China's export growth.

Severe flooding in the central and southern part of China is affecting agricultural as well as industrial production in these areas (the State Statistical Bureau estimates that floods cut grain output and dragged down economic growth 0.4 percentage point in the first half of 1998).

**New sources of economic growth**

In order to reach the growth target, various measures have been taken by the government to boost the economic and trade growth since the early 1998, including

- interest rate cuts (five times during the past two and half years including twice in 1998), each time within a narrow range reflecting government's cautiousness in finetuning its macro-economic policies)
- increase in investments by issuing treasury bonds and subsequent multiplier effect for investment expenditure (about 241 billion yuan of bonds were issued in 1997 and the total bond issue for 1998 is expected to be more than 300 billion yuan, with the result that investment growth hit 13 per cent in the first half of 1998, up from 10 per cent in 1997, but less than the minimum of 15 per cent required to reach the growth target, but fixed asset investments for 1998 are expected to surpass 15 per cent, about 5 percentage points higher than for 1997)
- increases in money supply (the broad money supply M2 rose 14 per cent year on year to 9.47 trillion yuan by the end of June and is expected to surpass 15 per cent for 1998 as the government is likely to apply more economic stimulus measures in the second half of this year)
- reducing bank reserve ratio from 13 to 8 per cent to boost banks' incentive for lending (new lending amounted to 376.4 billion yuan in the first half of this year)
- providing housing investments (which will account for about 15 per cent of total fixed asset investments in the next three years) and loans (100 billion yuan for 1998)
- preferential policy towards exporters and importers including expanded credits and increased tax rebates.
At the same time, some new sources of economic growth have been identified and advocated by the government which include

- infrastructure development such as roads, railways, telecommunications, irrigation, and rural electricity networks
- a housing project which is expected to generate developments and growth in about 50 sectors in the economy
- high-tech industries (computer and information industries)
- projects on environmental protection
- non-state sector development
- consumption of durables (providing car loans for example).

Choosing infrastructure development, housing sector and environmental protection as new sources of economic growth reflects the government’s intention of avoiding further large-scale investment in industrial sectors which have been subject to oversupply in recent years.

For example, the annual production capacities for colour televisions and refrigerators are 45 and 18 million, their utilisation rates are 46.1 and 50.1 per cent respectively. The utilisation rates for air conditioning units, washing machines and vacuum cleaners range from only 30-40 per cent. A rather extreme case is telephone production. The annual production capacity for telephone is 140 million sets, but the annual market demand is only 40 million (The People’s Daily, Overseas Edition, 22 June 1998).

**Constraints to the government growth strategy**

There are some favourable factors existing in the economy, such as low wages, low inflation, sufficient energy supply, a moderate level of foreign debt and a large amount of international reserves, which may help contribute to the achievement of the growth target. But the government is apparently facing various kinds of constraints to its growth strategy. Some of these constraints are related to the shift from a sellers' market to a buyers' market characterised by oversupply of both consumer and producer products. From a policy perspective, this shift means

- enterprise response to the adjustments of economic policies such as interest rate cuts will be slow and moderate because of the lack of new investment opportunities
- for the same reason, monetary expansion will be less effective in boosting demand for investments (with a shortage economy, enterprises will react quickly to increases in money supply); the government now has to rely more on fiscal means to increase the investment scale and sustain growth
with limited investment opportunities, too much expansion of the state-sector may squeeze the developments for the non-state sector which has been the most dynamic sector in the economy during the transition period

with a trend of declining profits for SOEs, sources for state revenue will be negatively affected, raising questions about the government’s ability to fund large-scale projects (state revenue rose 7.7 per cent between January and May in 1998, well below the 10.2 per cent target for the year, while expenditure grew 12.8 per cent instead of the 7.2 per cent as planned).

Other constraints include the following.

- There is a limit for further cuts in the official interest rate which is now only 0.22 percentage point higher than US dollar deposit rate. Further cuts will increase the demand for US dollars adding more pressure on the RMB exchange rate.

- There are problems and risks in the financial and banking system (outstanding loans reached 7.88 trillion yuan, up 15.6 per cent year on year by the end of June 1998) which may weaken the growth potential of the economy.

- There are problems of a persistent weak market demand and rising unemployment. The latter makes the price of structural changes even higher and therefore has important implications for the ongoing reform and liberalisation programs.

- In increasing investments in new sectors, the government has to pay attention to problems such as income distribution and widening regional disparities.

- The weak regional economy including the Japanese economy and the likelihood of further depreciation of the yen overshadows the growth prospects of the Chinese economy over the next 1-2 years.

**Side-effects of hasty expansion**

Questions have been raised about potential consequences and effectiveness of government expansionary policies in the context of the economic reform, long-term development as well as changing internal and external environment. Potential side-effects of such policies may include

- increases in duplicated investments in production and construction which cause inefficiency and wastage in the course of stimulating the economy, and therefore jeopardise the progress in changing the resource allocations achieved in the past (for example, profits earned by enterprises should be a good predictor of economic growth; but with state-owned enterprise budgets hardening as a result of the reform, these enterprises will respond to declining profits by reducing rather than increasing investments)
adverse effects on the reform progress in the structural adjustments and management of SOEs, for example, easy loans provided to those enterprises may soften the budget constraints which have been hardening resulting from the reform measures taken in the past.

increasing the possibility of plunging the economy into another round of stop-go cycles which afflicted the economy several times in the past, increasing the economic and social costs in the process of economic transformation (for example, several big investment-led booms during the past 20 years ended in severe policy retrenchment. The risk is that over-investment encouraged by government policies could lead to over-capacity, declining profits and eventually to a severe contraction of the economy.

with a weak market demand and over supply of products, a surge in growth rate may bring some short-term gains, but offset some long-term gains brought by the structural reforms.

How to avoid these side-effects

What's required is to realise that the success of the reform, which holds the key for a more sustainable long-run growth, cannot be greatly compromised in the course of stimulating the economy at this difficult stage of economic development. A wise decision may be to balance the objectives of economic growth and economic reform. In order to find the right balance between these objectives, the government should be more realistic and flexible in setting growth targets and achieving these targets by implementing appropriate reform and macroeconomic policies.

Prospects of economic growth in China

The short, medium and long-run growth prospects of the Chinese economy can be summarised as follows.

- **Short-run prospect (1–2 years)**
  
The Chinese economy experienced a lower than target growth rate (7 per cent) during the first half of 1998, but appears to retain some momentum (resulting from the current investment booms) to enjoy 7 per cent or more growth rate during the second half of 1998 and into 1999. But whether the momentum is big enough to reach the growth target of 8 per cent for 1998 is now questionable. Furthermore, questions also remain about the soundness of the growth resulting from hasty expansion and its implications for structural reform and medium-run growth prospects.

- **Medium-run prospect (3–5 years)**
  
Medium-run growth prospects will depend on whether and the extent to which the current boom sacrifices the progress of the economic reform and the achievement in structural
adjustments in the past and the likelihood that this will lead to a policy retrenchment and subsequent slowdown of economic growth in 2-3 years' time, entering into another round of stop-go cycles.

- **Long-run prospect (5–10 years)**

With the completion of major reform programs such as SOE and banking system reform and the establishment of modern enterprise, financial and banking systems, the economic and social costs of the economic reform will be considerably lower than those at present and in three years' time.

The institution-building compatible with an open market system will ensure both consumer and producer confidence and generating more investment opportunities. The market potential will be realised and economic growth will be more steady and sustainable.

There is, however, a possibility that the structural reform in the economy, especially of SOEs and banking system, cannot be complete in the next five years. Should that occur, the realisation of optimistic long-run prospects would be delayed accordingly.

**Conclusions**

Economic reform and institutional change can produce high economic growth by boosting incentives and high economic growth in turn can pave the way for carrying out further reform. The Chinese economy has come to a stage where a more delicate balance between growth and reform targets needs to be sought and maintained.

In order to find the right balance between growth and reform objectives, the government should be more realistic and flexible in setting growth targets and achieve these targets by implementing appropriate reform and macroeconomic policies. The eventual success of the reform will lay the foundation for a more sustainable growth in the long run.

The growth issues in China have to be approached, understood and dealt with in the context of ongoing economic reform. Whether the growth rate is 8 or 7.5 or 7 per cent is not that important in this context. What matters most is the `quality' of economic growth, namely whether such growth has been accompanied with an improvement in the economic structure, efficiency and productivity. It remains a challenge for the government to engineer such growth at this stage of the economic transition.