China's Economic Prospects and Challenges[1]
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China's phenomenal economic rise since it started to reform its economic system in 1979 is one of the major world events of the past 30 years. With its enormous population (currently 1.3 billion, approximately one-quarter of the world total) and spectacular GDP growth rates (averaging 9.5% over the past 26 years), China is on course to pass Japan and become the world's second largest economy in the next few years. China's economic emergence is having major trade, financial, political, and security impacts on the United States and the rest of the world.

One of the most striking aspects of this achievement is the reduction of poverty from more than 60% of the population at the start of economic reform to less than 10% today. China contributed a major share of world poverty reduction over the period. The fall in poverty occurred *despite* China's pattern of economic growth, which was heavily oriented toward relatively capital-intensive export industries, and not *because of* it. Although income grew most rapidly in the industrial sector, income from agriculture also rose and provided the main impetus for poverty reduction. The service sector remained underdeveloped. Economic growth in China has been uneven in spatial terms, with coastal urban areas benefiting most and some of the inland provinces left behind.

Economic growth was highly export-oriented and made China a leading source of a wide range of manufactured goods for the United States and other developed countries but left the country vulnerable to the current global recession. The value of exports fell by about 25% from mid-2008 on as demand for Chinese products collapsed in overseas markets.

Despite this vulnerability, an early and decisive government stimulus program, involving both monetary and fiscal policy, has enabled the Chinese economy to keep growing at relatively high rates during the current world recession and growth now appears to be accelerating once more. Aggressive loosening of credit and a surge in government spending, especially public investment in infrastructure, have averted a sharp economic downturn in 2009. Private investment and consumption have been much more subdued, although recently there have been signs of recovery in property development. The Economist Intelligence Unit (EIU) predicts that the government's target of 8% growth for 2009 will be exceeded, with the rate possibly reaching 8.2%. The EIU forecasts growth of 8.6% in 2010, then slightly slower growth at 8.4% in 2011 as the impact of the government's stimulus program fades. It notes, however, that GDP growth in 2010 could be higher than forecast if consumer confidence recovers more quickly than expected and manufacturers, especially in key industries such as automotive manufacturing, are forced to invest to expand their productive capacity. China would also benefit if the external picture improves faster than expected.

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The EIU and IMF expect that Chinese exports will recover as the world economy revives but anticipate that export growth rates in the next ten years will be lower than the extremely high rates achieved in the past decade. Continued rapid growth in Chinese exports could lead to increases in China's market shares in many product lines and heightened competition with other exporters that could force price decreases. Moving up the value-added chain, shifting the composition of exports, entering new industries, and increasing the domestic value added of exports would all provide opportunities for further expansion. However, the experiences of other Asian countries that adopted similar export-oriented growth strategies suggest that there are limits to the global market share a country can attain.

China's accumulation of enormous foreign exchange reserves has prompted charges from the United States, Europe, and the IMF that the renminbi is greatly undervalued and needs to appreciate substantially. Over the past five years, the current account surplus rose from 5% of GDP to 10% and rapid accumulation of foreign exchange reserves continues. Undervaluation of the currency has contributed greatly to global imbalances. Renminbi appreciation would be one important component of any strategy to encourage production for the domestic market. However, the Chinese government denies that the currency is substantially undervalued, points out that the renminbi has been allowed to appreciate to some degree and argues that exchange rate stability is desirable in the present unsettled international environment. Despite pressure from China's trading partners, the Chinese currency has barely strengthened against the dollar since July 2008. Some appreciation is expected over the next year or two as the economy continues to recover, but its pace is unknown.

A basic shift in development strategy toward production to meet domestic consumption needs has been urged by the IMF and apparently adopted by the Chinese government. The recession has forced some of this rebalancing and the question is whether it will be maintained as recovery ensues. Maintaining growth while steadily reducing China's dependence on exports and high levels of investment will require sustained progress on several fronts. At the household level, consumption will have to be raised and the level of precautionary savings, which has been extraordinarily high in the past because of China's history and a weak system of social safety nets, will have to be reduced. The financial system will have to be liberalized and developed. Corporate incentives must be reformed to reduce enterprise savings. It is unclear whether the Chinese government fully accepts this proposed strategy and will move rapidly to implement it. The EIU expects that the bias towards investment at the expense of consumption will continue in 2010 and 2011.

The government is committed to improving social services and safety nets. Y850 billion has been set aside to expand the coverage and improve the quality of China's health care system over the next three years. Also, the government has improved the coverage and portability of public pensions and now finances compulsory education through the ninth grade. Despite these improvements, households still face the need to self-insure against various risks.

The government of China is concerned about unemployment, including its possible relationship to internal discontent and upheavals such as occurred recently in Xinjiang Province. Rebalancing growth toward domestic consumption could create unemployment as workers in export industries are laid off. This could endanger remittances to rural communities.

Concern about unemployment has led the government to expand retraining programs, provide subsidies to individuals who start small businesses, institute policies to prevent both adults in a household from being laid off, and offering targeted support to college graduates.

Prices will fall slightly in 2009 and resume modest increases in 2010 and 2011. Declines in international food and fuel prices turned inflation negative in late 2008. The weakness of external markets means that increasing amounts of production will be channeled into the domestic market, heightening price competition and keeping prices down. Consumer prices are expected to fall by approximately 1% in 2009, then rise again by 2-3% in 2010 and 2011. Any disturbances affecting agriculture would bring about higher inflation, since food is the largest component of the consumer's market basket. Asset price bubbles resulting from loose monetary policy may also emerge.

Rapid growth in bank lending is causing some concern that the proportion of non-performing loans could rise. Local governments in particular have borrowed heavily and some (especially in poorer regions) may have trouble repaying their loans in the future. Such a situation is unlikely to bring about a financial crisis but could force the central government to intervene in order to assure the continuation of education and health services.

China's business climate has changed dramatically since the start of economic reform, but the government's regulatory capacity still lags behind business developments. In the early 1980s, China restricted foreign investments to export-oriented operations and required foreign investors to form joint ventures with Chinese firms. Since the early 1990s, however, foreign investors have been permitted to manufacture and sell a wide range of goods on the domestic market and even to establishment wholly foreign-owned enterprises. China has become the leading platform for overseas production and is now one of the world's leading recipients of FDI. Major remaining barriers to foreign investment include opaque and inconsistently enforced laws and regulations and the lack of a rules-based legal infrastructure.

Many Chinese businesses, faced with mounting competition and poor oversight, appear to have sacrificed consumer safety in their search for increased profit margins, often at the expense of consumer safety. The Chinese government has recognized the severity of this problem, recently concluding that up to 20% of the country's products are substandard or tainted and initiating measures to deal with the issue.

China ranked 89th, near the middle of the pack of 184 countries covered, in the 2010 edition of the World Bank's ease of doing business index. This represented slight slippage from a 2009 ranking of 86th, indicating that some other countries are reforming business regulation faster than China. Especially weak areas for China are dealing with construction permits (180th), employing workers (140th), starting a business (131st) and paying taxes (130th). Relatively strong areas are enforcing contracts (18th), registering property (32nd) and trading across borders (44th). Only a single regulatory reform was reported since the previous edition of *Doing Business*.

China's rapid industrial development has greatly increased pollution and degraded natural resources. China is believed to have passed the United States recently as the world's largest emitter of carbon dioxide and other greenhouse gases. Pollution of air and water is common, with deleterious effects on health. The Chinese government is paying increasing attention to environmental issues and engaging in international negotiations on the subject.

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