



## China in Asia Seminar Series

### Seminar 2: How Sustainable is China's Economic Growth

April 21, 2005

#### SUMMARY

##### Nicholas Lardy (Institute for International Economics)

Chinese economic growth is likely to be sustainable. Critics cite a laundry list of potential problems and argue that one or more will derail Chinese economic growth. Bad loans and financial sector weakness, water shortages, growing energy demand, rising inequality, and environmental damage are all real challenges. However, one could have come up with a similar list of challenges twenty years ago; China has managed those issues successfully. A better approach is to examine the key factors that have produced China's economic success, and ask whether they are likely to continue. On balance, Dr. Lardy believes that they are.

The first key factor is the rise of the market. In stark contrast with twenty years ago, prices of almost all products and labor in China are now set by market forces that reflect scarcity and supply and demand. Previously, prices were set by administrative fiat, which misallocated resources and meant that enterprise profits were determined by whether firms could buy cheap inputs and sell output at higher prices. This system was gone; most sectors of the Chinese economy are now characterized by strong competition. The days of graduates being assigned a job and working in one enterprise for their whole careers are over. China now has a much more efficient labor market where there is competition for jobs and labor turnover. Dr. Lardy acknowledged that the Chinese capital market is inefficient in allocating capital, but noted that the fact that reinvested profits are the most important source of investment capital helps to compensate for these weaknesses.

A second key factor is China's very high savings rate, which has supported a high investment rate. China's savings rate has risen from 30% in the 1970s to more than 40% today. This is the highest savings rate in the world (except for Singapore). China's capital market has not allocated this money efficiently, but the high savings rate has allowed for increases in the capital stock.

A third factor is the intersectoral transformation of China's labor force. Workers have been moving from the low productivity agricultural sector to the higher productivity manufacturing and services sectors. China has moved from having 90% of the population in the agricultural sector to about 50% today.

A fourth factor is China's openness to foreign trade and investment. China differs greatly from Japan and India in its openness, which forces increases in competition, efficiency, and productivity. Chinese import tariffs are quite low, with an applied rate of less than 10% and an actual rate of less than 3%. This helps the manufacturing sector get imported inputs, and contrasts with Indian tariffs which are three times higher and make the Indian

manufacturing sector uncompetitive. China has also eliminated almost all import quotas and licenses. Imports now make up about a third of the Chinese GDP, compared with 9% for Japan and 14-15% for the United States. Lardy noted that China has attracted more than \$500 billion in foreign investment. About 25% of Chinese goods are manufactured by foreign firms, which now sell about half their output in China (almost \$400 billion per year). Economic openness forces domestic firms to improve their efficiency in order to survive.

In assessing the future, Dr. Lardy noted that the biggest challenge is the poor efficiency of the capital market. China would benefit greatly from equity and bond markets that really work. However the current system is so bad that “there is nowhere to go but up.” 100-200 million more farmers are likely to move to the manufacturing/service sector over the next 10-20 years, providing a continuing productivity boost. China’s goods market is relatively open, and China’s WTO commitments mean that the services sector will open further in 2006 and 2007. One big uncertainty is a possible decline in the savings rate as China’s society ages and the ratio of workers to retirees shifts in 10-12 years. However, this could be offset by increased efficiency in capital allocation. Dr. Lardy concluded that China could continue to enjoy growth in the high single digits for at least another decade or longer.

Despite this overall conclusion, Dr. Lardy highlighted the possibility of a significant economic slowdown in the next two to three years. One problem is accumulating risks in the financial sector. The extremely high rate of fixed-asset investment (about 45% of GDP) is being used inefficiently and is likely to decline; neither increased consumption nor government spending will fully compensate. China will likely seek to maintain growth through increased net exports, but there are real questions about whether the world would accept a China with a current account surplus of more than 5% of GDP. This is an indication that China’s currency is significantly undervalued.

### **Mikkal Herberg (National Bureau of Asian Research)**

China’s increasing energy demand to fuel rapid economic growth is changing the face of global energy geopolitics and forcing Beijing to become a major player in the Middle East, Central Asia, Africa and Latin America.

Energy demand in China is high and projected to grow rapidly over the next 15-20 years, but supplies will come mainly from “dirty” sources such as coal and oil. By 2020, coal use will increase by 40% and oil use by 30%, with disturbing environmental implications. A key challenge is meeting growing electricity demand without excessive reliance on coal. Despite tremendous investments in nuclear power and hydropower to generate electricity, energy in China always faces a problem of scale. China plans to build two nuclear power plants a year for the next 20 years, but this will fulfill only 3% of energy demand. The huge Three Gorges Dam project will only meet 2% of China’s energy needs. Because Chinese firms use energy inefficiently, price reforms that reflect the actual price of energy are the key to reducing domestic demand and increasing efficiency.

Chinese demand is not the only factor driving energy prices: energy demand is on the rise throughout developing Asia. Asia's future oil import needs will rise from 14.4 million barrels a day in 2002 to almost 40 million barrels by 2030. Most of this oil will come from the Middle East. China will make up over 50% of Asian energy consumption growth, and 20% of global energy consumption growth.

Transportation is a major driver for rising Chinese oil demand. Vehicle usage currently stands at 40 million, but is expected to rise to 140 million by 2020. Fuel choices, engine choices, and availability of public transportation could check the impact on oil demand. Chinese leaders are beginning to address some of these issues, but the scope and political sensitivity of the problem complicates this effort.

Increasing demand and high oil prices are causing consternation throughout Asia. The belief that global oil production will peak in the near future (which Mr. Herberg does not share) fuels a sense of scarcity and anxiety about securing energy for future growth. Chinese "oil angst" has produced a strategy of "energy nationalism." China's leadership views energy through a mercantilist, zero-sum lens and feels energy security is too important to leave to the market. Chinese oil companies are converging on regions where energy resources are available—the Persian Gulf, Western Africa, Russia, Central Asia, and even Venezuela—in a rush to secure rights to supplies. They are also increasingly concerned about potential choke points like the Strait of Malacca.

How China's energy consumption affects the rest of Asia depends on general Asian approaches to handling China's rise. If the process is peaceful, then energy should not become a major issue. If the rise is bumpy, energy could become a bone of contention and further aggravate existing regional rivalries. APEC has been trying to carve out a cooperative role and there is potential for cooperation on a gas pipeline in Northeast Asia, but progress has been slow on both fronts.

Mr. Herberg asked whether energy might become a bone of contention between China and the United States. The issue is highly politicized in both countries. China worries about growing U.S. influence in the Persian Gulf and Central Asia and about U.S. control over the sea lines of communication from the Middle East to Asia (including the U.S. ability to cut off Chinese oil supplies in the event of a Taiwan crisis). The Middle East-China nexus will continue to grow. In the future, China will have the ability to use energy diplomacy and stronger bilateral ties to affect the security architecture of global energy.

## Q&A

An audience member noted that when developed countries dealt with the energy crisis in the 1970s, they recognized the need to manage the crisis collectively. Cooperation took years, but eventually resulted in the International Energy Agency. Mikal Herberg acknowledged the need for international cooperation despite its difficulty, but noted that Asian countries are not seriously discussing this. He argued that it is important to bring China and India within an international framework for energy cooperation. There have

been some interesting proposals, such as a regional oil reserve set up with U.S. funds, filled with Middle East oil, and located in Southeast Asia.

In response to a request for details on Chinese internal energy reforms, Mikkal Herberg noted that the energy sector is far behind the rest of the economy. Although the government has undertaken some reforms, the political sensitivity of the issue and pressure from businesses and consumers has bogged down forward movement. Dr. Lardy commented that by the late 1990s China had built a system that priced oil at international prices, but that it has fallen by the wayside as Chinese leaders became concerned about the negative economic impact of higher prices.

Dr. Phillip Saunders asked about state influence on Chinese oil companies given the current situation where domestic prices are kept artificially low and companies are making investments based on inflated prices abroad. According to Mr. Herberg, Chinese companies are responding to state pressure rather than maximizing profits. Since oil prices are unlikely to remain this high, such deals do not make a lot of economic sense. The Chinese would be better off relying on the market.

Dr. Robert Sutter noted that the picture seemed to be one of a China with an endless supply of money. He asked what Chinese companies are investing in, whether currency reserves are being utilized for these deals, and whether we can believe official Chinese figures. Dr. Lardy doubted that foreign exchange reserves are being used overseas; investment and foreign aid is probably being financed through the state budget and Chinese banks. He agreed that official investment figures are laughably low and do not begin to capture all that is going on. Mr. Herberg cited the example of a reported \$25 billion Chinese deal with Australia that actually involves only a \$500 million equity investment coupled with gas purchase commitments spread out over 25 years.