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China Research Report

***Social Stability as the Key to Sustainable Growth:
Transition to democracy and a system in line with international
norms needed***

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Against the backdrop of the collapse of an “asset bubble” and the deceleration of the world economy, the Chinese economy will likely reach a turning point even before the opening of the Beijing Olympics in August. After an adjustment phase, in order for China to maintain high growth over the medium and long terms, it needs to proceed with long-delayed structural reforms and press ahead with the building of a harmonious society. This will require a transition to democracy and the building of a system in line with international norms.

The Beijing Olympics in August will be a touchstone for the achievements of 30 years of liberalization and reform policies in China. The Games’ success will mark the year 2008 in history as the year symbolizing the “re-emergence of China.” However, soaring prices and plummeting stock prices in China, combined with the deceleration of the world economy, are rendering the country’s macroeconomic conditions increasingly harsh. The key to maintaining growth over the medium and long terms lies in whether China will be able to carry out long-delayed reforms. With this in mind, the Japan Center for Economic Research (JCER) has compiled a report, “China after the Beijing Olympics” (co-chaired by this writer and Professor Zhu Jian Rong of Toyo Gakuen University).

Reaching a Turning Point before the Beijing Olympics

In 2007, the rate of economic growth in China stood at 11.4 percent, with the economy posting double-digit growth for the fifth consecutive year. Meanwhile, interventions in the foreign exchange market to curb the appreciation of the renminbi (RMB) have caused the money supply to increase rapidly, resulting in the swelling of liquidity. As a result, inflation has accelerated and asset prices, including the prices of real estate and shares, had soared. In the stock market, in particular, helped by progress in non-tradable share reform, the Shanghai Stock Exchange Composite Index exceeded 6,000 points on October 15, 2007, the first day of the 17th National Congress

of the Communist Party of China, increasing six-fold in a little over two years.

Subsequently, against the backdrop of turmoil in the financial markets triggered by the subprime loan (home loans to less credit-worthy individuals) problem in the United States, monetary tightening in China designed to curb inflation and the appreciation of the RMB, share prices have entered an adjustment phase. Yet, relative to corporate earnings, current share prices still appear to be overvalued. Furthermore, the planned lifting of the ban on the sale of state-held non-tradable shares, scheduled for most listed companies from 2009 onward, is causing worries about the deterioration of the supply-demand relationship in the stock market. Thus, stock prices may fall further. The decline in share prices will put a damper on consumption and take the edge off corporate investment. On top of all of this, exports will decelerate due to the deteriorating world economy. Hence, the Chinese economy will likely reach a turning point before the opening of the Beijing Olympics in August.

As in the case of Japan prior to the 1964 Tokyo Olympics, China has intensively invested in related projects in preparation for its Olympics. Thus, it is widely believed that once the Games are over, the economy will take a downturn as the pre-Games construction boom fades. Indeed, China is now at a stage of economic development equivalent to that of the Japanese economy around the time of the Tokyo Olympics. However, given that China's population is about 10 times that of Japan, it is safe to assume that the present size of the Chinese economy is roughly 10 times that of Japan's back at the time of the Tokyo Olympics. Thus, after the Olympics, the expected decline in investment may lead to slower growth in Beijing and nearby areas. Such adjustments, however, will not be large enough to pull down the nationwide growth rate substantially. Rather, greater causes for concern are a further surge in inflation and the collapse of the bubble.

Pattern of Growth Must Shift on Both Demand and Supply Sides

The bursting of the bubble and economic deceleration are adjustments needed for the Chinese economy, as they will inevitably spur structural reforms, which have long been postponed. In order to maintain a balanced growth in the medium and long terms, changing the nation's growth pattern and building a harmonious society are urgently called for.

The growth pattern must change in two aspects: On the supply side, it must shift "from the expansion of input volume to an increase in productivity," while on the demand side, it must shift "from dependence on exports and investment to a more balanced pattern, which will also include consumption."

On the supply side, high economic growth in China since its reform and opening has been achieved through the expansion of the volume of input (capital, labor force, etc.). The problem is that China's productivity is not necessarily high. Emerging constraints on the input side, such as worsening environmental problems, soaring wages and primary product prices, including the price of energy, are causing doubts about the sustainability of high growth.

With the aim of shifting the growth pattern from expanding input volume (extensive growth) to increasing productivity (intensive growth), the 11th Five-Year Plan (2006-2010) emphasized 1) improving the efficiency of resource utilization; 2) enhancing sustainable development; 3) improving capability for independent innovation; and 4) upgrading of industrial structure. However, the root cause of the persistence of extensive growth is the negative legacy of the old regime. To achieve a shift to intensive growth, the market economy system must be put in place through, among other things, the privatization of state-owned enterprises and the fostering of private enterprises. These measures should improve the international competitiveness of Chinese products.

At the same time, anticipated progress in urbanization is expected to improve productivity. As urbanization shifts the center of industry from low-productivity primary industries to high-productivity secondary and tertiary industries, the productivity of the economy as a whole will rise. Moreover, urbanization improves productivity through agglomeration effects, which stem from the geographic concentration of economic activities.

Three large metropolitan areas have already been formed: the Yangtze River Delta, with Shanghai as its nucleus; the Pearl River Delta, centering on Guangzhou and Shenzhen; and the Beijing-Tianjin-Hebei region, which are becoming the engines of the Chinese economy.

On the demand side, as high growth in recent years has been led by exports and investments, the share of consumption in the gross domestic product (GDP) has declined. The greatest factors in the stagnation of consumption are 1) state-owned enterprise reforms have increased joblessness and temporary layoffs, causing uncertainties about the future, which, in turn, have resulted in increased savings; and 2) the further concentration of income to high-income groups, whose savings rate is high and whose propensity to consume is low. Thus, to expand consumption, enhancement of the social security system and correction of income inequality are necessary. The expansion of domestic demand, centering on consumption, is expected to rectify China's external disequilibrium by increasing imports and thus contribute to the easing of trade friction.

The present income inequality in China is far greater than that in Japan back in the 1960s. In order to spread the fruits of economic development among the people, the government is aiming at a "harmonious society." However, this has not produced expected results because of resistance from those with vested interest. In order to surmount the barrier of "agree in general, but oppose in specifics," it will be necessary to establish a mechanism for the resolution of conflicting interests by, for example, increasing participation in the political process through democratization thus restoring the stability of politics and society.

Conversely, as the experience in many other countries demonstrates, the prerequisites for a soft landing to democratization include that 1) the economy has developed to the level of middle-income nations; 2) the middle class is the mainstream of society; and 3) there is fair distribution. Indeed, the top priority for the regime of

President Hu Jintao and Premier Wen Jiabao, now in its second term, is to establish a virtuous circle between building a harmonious society and progress in democratization.

Wipe Away the Concern of the International Community

Through its high economic growth and the strengthening of its armaments, China has increased its “hard power” (i.e., economic and military power) to become a “superpower.” However, the government is aware that for China to leap to the status of a “powerful nation,” it needs to increase its “soft power” as well as its “hard power.” Soft power here means the ability to obtain desired results through its own attractiveness as a nation. Culture and policies are wellsprings of such power.

While the United States promotes the “Washington Consensus” based on strong faith in the market mechanism as a strategy for economic development, China has adopted what has come to be known as the “Beijing Consensus,” which calls for step-by-step liberalization. To a certain extent, the latter has won esteem from developing countries and has helped China increase its soft power. China is aggressively engaged in international cultural exchange and is cooperating with developing countries. For example, it is establishing “Confucius Institutes,” (schools for promoting the Chinese language education and Chinese culture) globally, as a new source of its soft power.

Nevertheless, there are still many impediments to the expansion of China’s soft power. Specifically, they are: 1) Problems in its political system, such as the slow process of the establishment of democracy and freedom of expression; 2) the corruption of power and the decline in ethics; and 3) international criticism directed at its diplomacy, which is felt to be overly biased toward its national interests and the expansion of its armaments. As long as these problems remain unsolved, the United States, the European Union (EU), Japan and others will not recognize China as a partner in the international community and continue to view it as a threat.

China is aiming at “peaceful development.” However, in order to attain this goal, China must wipe away the concerns of other countries by building a system and executing its policies in accordance with international norms. Following its accession to the World Trade Organization (WTO) in 2001, this year’s Beijing Olympics should be recognized as a major step toward this goal.

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