The People’s Republic of China is currently the second largest economy in the world, with the world’s fastest growth rate and largest population.
China is also still an economy in transition from a poor, rural command economy to a dynamic and prosperous market economy, with a stark contrast between a large and mostly poor rural population, and relatively advanced, westernized, and wealthy cities.

Governance

- China is run by the Chinese Communist Party. Provincial/municipal governments are appointed by the central administration.
- The Chief of State is President HU Jintao, who is more importantly General Secretary of the CCP. The President is appointed by the National People’s Congress to up to two five-year terms.
- The Head of Government is Premier WEN Jiabao, also appointed by the NPC, together with the entire State Council.
- China’s appointed leaders are all members of the CCP, as are most representatives to the NPC.
- The CCP will appoint new leaders in Fall 2012 (e.g., XI Jinping), then the NPC in Spring 2013.
China’s annual **Gross Domestic Product**
was 40 trillion Yuan (Renminbi) in 2010.

- about $6 trillion at official rates.
- almost $4,500 per capita.

USA GDP is about $15 trillion.

- almost $50,000 per capita.

China’s currency undervalued: purchasing power parity comparison is almost double (17% of U.S. level).

China’s annual real per-capita growth rate has averaged 8% since reform began, and about 9% over the last decade.
Why Has China Grown?

- Economic reforms since 1978.
- Foreign Trade openness after 1984.
- Undervalued exchange rate after 1994.
- Foreign Direct Investment after 1997.
- Internal Migration from rural to urban, agricultural to manufacturing.
- High rate of private savings.
- Public investment in public infrastructure, particularly during global downturns.

China’s future?

IF the PPP numbers are accurate, and IF China and the U.S. could maintain the same growth rates as over the last three decades...

- China will be the world’s biggest economy (in PPP terms) in six years, and twenty years if the currency remains undervalued.
- It would take thirty more years for China to overtake the U.S. in per-capita income.

But even though China invests more than it consumes, such high rates of growth are not possible to sustain once an economy catches up with the leaders. Especially not for an export-driven economy in which productivity improvements come from the movement of rural labor into light industry.
China’s population is 1.3 billion people, now growing at only 0.5% per year.

China’s land area is roughly 3.7 million square miles, compared to 3.5 for the USA (including 0.6 in Alaska). The U.S. is bigger if you include water (the Great Lakes).

Most Chinese live in the east, and until recently the vast majority lived in rural areas.

China has significantly less farmable land than the USA, so the density per unit of arable land is almost nine times that of the USA.
Historical Background

- Longest continuous civilization: at least 8000 years of cultural artifacts, 4000 years of good written history.
  - Middle Kingdom centered on Yellow River.
  - Early dynasties: Xia (2200 BCE), Shang, and Zhou.
- Empire unified in 221 BC by Qin Shi Huangdi.
  - Han Dynasty, 206 BCE - 220 CE
- Middle Empire:
  - Sui reunification/Tang Dynasty, 581-907.
  - Song Dynasty, 960-1279, gradually lost China to Qidan, Nüzhen, finally the Mongols (creating Liao, Jin, and Yuan dynasties).
- Late Empire:
  - Ming Dynasty restoration, 1368-1644.
  - Manchus replaced it with Qing Dynasty, 1644-1911.
Imperial China

- **The Middle Kingdom** was the world’s most advanced society and economy for much of human history.
- **Dynastic Cycle**: stable imperial autocracy divided by periods of chaos, with collapse created by revenue crises and weakening center. Internal power struggles before Song, foreign invasions after.
- **Large population**: cheap abundant labor, premodern agricultural technologies, gentry-supported backward-looking imperial state, Malthusian tensions.
- **The Opium Wars** (1840-42, 1862) coincided with decline of average income, population, Qing power.
  - Taiping Heavenly Kingdom: estimated 30 Million died.
  - Rise of regionalism: ZENG Guofan, LI Hongchang.
  - Slicing the Melon: missionaries, foreign concessions.
  - Century of Humiliation: unequal treaties, indemnities.

Technology

Ancient Chinese invented many things before the West:

- Pottery, tea, and silk, of course.
- Papermaking, printing, gunpowder, the shadow clock, abacus, seismometer, crossbow, compass, iron plow, propeller, suspension bridge, parachute, seed drill, double-action piston pump, etc.
- In the 1200s, China produced much more pig iron than England did in the 1700s. They also used natural gas for fuel, and could deep mine.
- During the early Ming, China had bigger ships going longer distances, a century before Europeans.
- Until 1750 or so, China was arguably a more advanced society than any in the West.
- Needham Paradox: Why did China not continue?
- Alternatively: Why did China grow, but not develop?
The People’s Republic

- PRC founded on October 1, 1949: CCP Chairman MAO Zedong announced that “The Chinese people have stood up.”

- First Five Year Plan, High Tide of Socialism in 1950s: nationalization, agricultural collectivization, Soviet advisors and loans, Soviet-style planning, heavy industrialization.

- Great Leap Forward, 1958-61: rural industrialization, large-scale agricultural communes, top-down methods, politics in command, vast misinformation, break with USSR, agricultural surplus taken to cities. Initial news very good, truth was awful: 30 million starved in famines (first rural, then urban), estimated 50 million fewer Chinese by 1961.

- Cultural Revolution, 1966-76: red guards, attacks on “four olds” and purges of Mao’s competitors, breakdown of education, public order, and planning, near civil war in 1967. Radical policies continued until Mao’s death.

China’s Population Under Mao

- Decrease of 10 million people
- Annual growth rose from 2% to 3%
- 50 million people fewer than Trend

Millions of People...
DENG Xiaoping

- Intelligent and popular figure within CCP.
  - General secretary during anti-rightist campaign.
  - In Dec. 1978, Deng became “paramount leader” after proteges chosen for highest positions.

- “Politics in Command” ended:
  - Authority based on skills
  - Rehabilitation of rightists, end of class labels.

- No more personality cults:
  - Chairman position abolished,
  - Term limits on highest positions.

- Party legitimacy still depended on Mao’s reputation, so CCP repudiated most of his policies with repudiating him.

- Pragmatic “black cat, white cat” approach.

Deng’s Economic Reforms

- **Open Door Policy** : China was opened up to foreign visitors, foreign investors, and foreign trade.

- **Rural Reform**: Land was allocated to families instead of to large communes. Rural towns and villages could invest in and produce manufactured goods.

- **Industrial Reform**: State-owned firms were reformed to try to make them more efficient. They became more productive, but also were able to get more investment than they could productively use, while more competition and poor management led to falling profits for the state.
Open Door Policy

- Foreign exchange retention for SOE exports.
- Special Economic Zones opened to FDI:
  - 1980: Shenzhen, Zhuhai, Shantou, Xiamen.
  - 1984: Shanghai, Tianjin, Qingdao, Wenzhou, Guangzhou, and nine other cities.
  - By 1990: Hainan, Shanghai Pudong, dozens of others.
- Joint-Ventures with foreign firms.
- Creation of dual currency system: FEC and RMB.
- Gradual opening to tourism.
- Chinese students able to study abroad.

Rural Reform

- Productivity stagnant in agriculture under Chairman Mao, all growth extensive, no rural industry after 1961.
- Under Deng, decentralization of collective farming (Communes, Brigades, Teams), contracts.
- Encouragement of rural and urban farmers’ markets.
- Division of land by household in Anhui, adopted by CCP as Household Responsibility System (Baogan Daohu), pushed top-down by 1984.
- Rapid productivity improvement, end to extensive growth.
- Rural Township and Village Enterprises (Xiangzhen Qiye).
- Release of surplus labor: rural teams, floating population.
- Rising rural wealth near cities: “To Get Rich is Glorious!”
Industrial Reform

Reforms really launched in 1984:
- Decentralization, SOE managerial autonomy, with contracted responsibility systems.
- Profit retention for bonuses, investment.
- Dual-track pricing system, ending ratchet effect.
- Banking reforms and commercialization to replace state allocations with loans.
- Getihu system for small firms, leasing of small SOEs.
- Basic problem of competition, profits, and inflation.

SOEs improved productivity in 1980s but also started to borrow heavily from state banks, and by late 1980s competition, rising productivity from other sectors, and SOE inefficiency was leading to falling profits and falling market shares.

Retreat from Reform?

- CHEN Yun a critic of Mao, advocated “Birdcage Economy.”
- By late 1980s, inflation and corruption were causing protests inside and outside the CCP.
- Student protests in 1987 led to ouster of CCP General Secretary HU Yaobang, replaced by Premier ZHAO Ziyang.
  - Zhao pushed for more reform, tolerance of private sector and wholly-owned foreign firms.
  - Blamed by CCP conservatives for reform problems.
- Large Tian’anmen protests after death of Hu led to a crackdown in June 1989, ouster of Zhao, and worsening of international relations.
  - New leadership included JIANG Zemin and LI Peng.
- Retreat from reform in 1989-1991 did not help SOEs but did lead to millions of rural job-seekers coming to the cities.
- Deng Xiaoping’s trip to Shenzhen in 1991.
The Socialist Market Economy, 1992 –

- Under President JIANG Zemin, the CCP renounced the idea that economic reform was just a temporary stage.
- The new policy was to create a developed market economy with the CCP in charge. State firms would be the “cornerstone” but not necessarily the dominant type of firm.
- The currency was unified and devalued in 1994, and the current account became “convertible”.
- Most state firms were transformed into LLCs. The best could raise money by going public – state kept controlling share.
- State banks were split into commercial and policy banks.
- Tax and Fiscal reforms addressed the revenue problems.

China’s Changing Industrial Structure

- New Chinese private firms, wholly-owned foreign firms allowed, but these have had relatively less access to bank loans or the stock market.
- Policy of “release the small, retain the large” for state firms, leading to huge layoffs in 1990s and creating large Korean-style firms.
- Export sector dominated by rural firms, foreign-owned firms, and private firms; relied upon to deal with urban unemployment problem.
Leading Trading Nations, 2009

<table>
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<tr>
<th>Country</th>
<th>Exports Billion $</th>
<th>Share</th>
<th>Country</th>
<th>Imports Billion $</th>
<th>Share</th>
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<tr>
<td>China</td>
<td>1,202</td>
<td>9.6%</td>
<td>USA</td>
<td>1,605</td>
<td>12.7%</td>
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<tr>
<td>Germany</td>
<td>1,126</td>
<td>9.0%</td>
<td>China</td>
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<tr>
<td>USA</td>
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<td>8.5%</td>
<td>Germany</td>
<td>938</td>
<td>7.4%</td>
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<tr>
<td>Japan</td>
<td>581</td>
<td>4.6%</td>
<td>France</td>
<td>560</td>
<td>4.4%</td>
</tr>
</tbody>
</table>

- China’s trade surplus is mostly with the USA. It runs a deficit with the rest of the world.
- China’s trade surplus has been narrowing recently.

Foreign Investment

- By 2006, China was receiving over $70 billion in Foreign Direct Investment per year.
- China the largest FDI recipient in less-developed world.
- Also technically the largest recipient in the whole world, but this amount included amounts from Hong Kong.
- After HK, the USA is the largest investor in China.
- Roughly half of Chinese exports to U.S. come from American-invested firms, who remit profits to U.S.
China’s entry into the World Trade Organization

- China an original member of the GATT, but seat was kept by Taiwan from 1949 until the 1970s.
- China was given MFN status under the Jackson-Vanik amendment, but this required an annual review of its human rights record.
- China was finally admitted into the WTO (along with Taiwan), and agreed to open its import, telecommunications, and banking sectors to foreign competition and investment. Chinese tariff rates came down dramatically.
- China is seen by many as dragging its feet, especially in banking, but trade and investment have nonetheless dramatically expanded.

State Banking

- China has four big state-owned banks (BOC, ABC, ICBC, CBC), two of which now are partially owned by private owners, plus a number of other smaller national and city banks.
- Local governments have had influence over bank lending, and loans have been biased towards state firms.
- Banking is poorly regulated, and there have been a number of major cases of bank officials diverting very large sums.
- Banking had a high non-performing loan ratio of 25-50%.
- Under Premier ZHU Rongji the gov’t tried to address the problem, with mixed results.
- China has a very high savings rate, and deposits remain in state banks due to implicit state guarantees.
International Trade has risen as a share of GDP
Investment (and Savings) is high and rising too!

China’s urban landscape has been suddenly transformed
Not always for the best...

Rural China

- Most Chinese still live in rural areas, on less than $2 per day.
- Rural areas continued to have large surplus labor problem:
  - Many worry about effect of U.S. agricultural imports on farm prices.
  - Recent reports suggest this labor surplus may be going away.
- Reports of protests by farmers over extractive rural leaders.
- Some local elections.
- Widening poverty gap between rural and urban areas.
Education

- Literacy rate is roughly 90%.
- China has more than 30 million new high school graduates per year, plus 2.4 million traditional college graduates, 1.9 million returning adult graduates, and 150,000 advanced graduates.
- The most popular majors for advanced graduate study are engineering, management, science, medicine, and law.
- China’s exports have typically been concentrated in labor-intensive products that used to be produced by other Asian countries, but China is starting to move into more higher-tech areas.
- China’s government is making a major investment in its universities, attracting back professors from top-ranked schools in USA and elsewhere. Qinghua, et cetera.

Stock Markets

- Foreign investors segmented into B shares market (USD in Shanghai, HKD in Shenzhen) – Forex capital transactions are still not convertible.
- Only state’s best performers initially allowed to list, but state still controlled a majority of shares – stocks a way to raise capital from public without privatizing.
- Market stagnant from 2001-2006, then bubble began.
  - Shanghai Composite Index rose 167% in a last year, as Chinese consumers look for higher returns.
  - P/E ratios twice as high in Shanghai than HK, for the same firms.
  - Cheng argued 70% of listed firms bankrupt, should be delisted.
In 2008, the SSE lost 70% of its value!

China’s Exchange Rate Controversy

- China pegged RMB to the Dollar in 1994 at the black market rate, which made China’s exports even cheaper. Currency had been considered overvalued.
- Inflation in mid-1990s quickly eroded devaluation.
- China did not devalue RMB as expected in 1997 Asian Financial Crisis, to great relief of its neighbors.
- China’s inflation rate was lower 1997-2005, and the currency became more desirable because the expectation of appreciation provided implicit insurance.
- China now accounts for more than 10% of U.S. imports, and is blamed in USA for loss of manufacturing jobs – though China has lost many times that amount.
- China runs a large current account surplus with the U.S. but a deficit with the rest of the world. Net trade surplus plus financial account surplus → BOP surplus.
Real Exchange Rate for Chinese Yuan (RMB) in 2011 US Dollars

33% Real Appreciation from 2006 to 2011

Will the Currency Keep Appreciating?

- BOP Surplus from trade surplus, FDI inflow.
- RMB rate kept low through massive purchases of U.S. Bonds by People’s Bank of China, which now holds almost $2 trillion of US government debt alone.
- The problem is that these purchases of foreign reserves increase the money supply, and can be inflationary.
- Money supply growth was checked by selling other central bank assets, and money demand grew too.
- China now facing rising inflation, and faces a choice: either RMB must appreciate more to end BOP surplus, banks will have to tighten lending, or inflation rises.
In real terms, Yuan has appreciated since 2006

What if the Chinese stop lending?

“If you owe the bank $100 that's your problem. If you owe the bank $100 million, that's the bank's problem.” - J. Paul Getty

If the U.S. owes foreign central banks $1 trillion, then what happens if they think we can't pay them?

- Debt denominated in Dollars, depreciation hurts Chinese.
- Depreciation of U.S. Dollar will increase exports and value of U.S. FDI in China, but will make U.S. imports expensive.
- Interest rates will rise, along with the U.S. risk premium, increasing budget deficit.
- U.S. Treasuries world’s safest asset. Higher risk could cause a new financial crisis, default a complete meltdown.
- U.S. also loses future seignorage from Dollar’s use.
Fiscal Policy

- Asian Financial Crisis of 1997 slowed China’s exports: offset by increased government investment plan.
- Great Recession led to significant drop in world trade.
- Chinese Economic Stimulus Plan of 2008–2009:
  - 4 Trillion RMB spending plan (12% of GDP) to be spent on public investment, a quarter by central government, the rest by local and provincial governments.
  - In contrast, Obama spending plan was less than $1 trillion (5% of GDP), a third in form of tax cuts, a third in public infrastructure, and a third to states to offset their budget cuts in education (but state and local governments still cut enough to offset most of federal government spending increase).
- Critics argue that China already overheated, already overinvesting, so fear stimulus will worsen inflation.
- Budget deficit rose from 0.4% to 2.3% in 2009.

China’s Housing Bubble

- Massive construction of new housing, with privatization and consumer loans (20% or more down).
- Massive migration from rural areas plus urban development, high savings rates and huge bank deposits.
- Housing in major cities rose to $130/㎡.
- Tightening monetary policy, rising interest rates, bubble appears to have peaked.
- Worries of a property price collapse leading to decline in consumer wealth, but financial collapse less likely and Chinese reserves very high.