

China's Medium-Term Prospects



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Where is China headed?

- Scientific Development!
- Per capita GDP should quadruple by 2020.
- Implied annual growth rate of 12.5 percent.
- By 2012, China's economy will be 80 percent larger than it is today.

Source: Hu Jintao, quoted in People's Daily Online.

Or, if you prefer the IMF...

- Forecast reported only through 2008.
- The IMF also described China as the biggest contributor to world economic growth.
- Rather daring in its prediction that things will keep going as they are.

Year	GDP growth	Inflation	Current Account
2005	10.4	1.8	7.2
2006	11.1	1.5	9.4
2007	11.5	4.5	11.7
2008	10.0	3.9	12.2

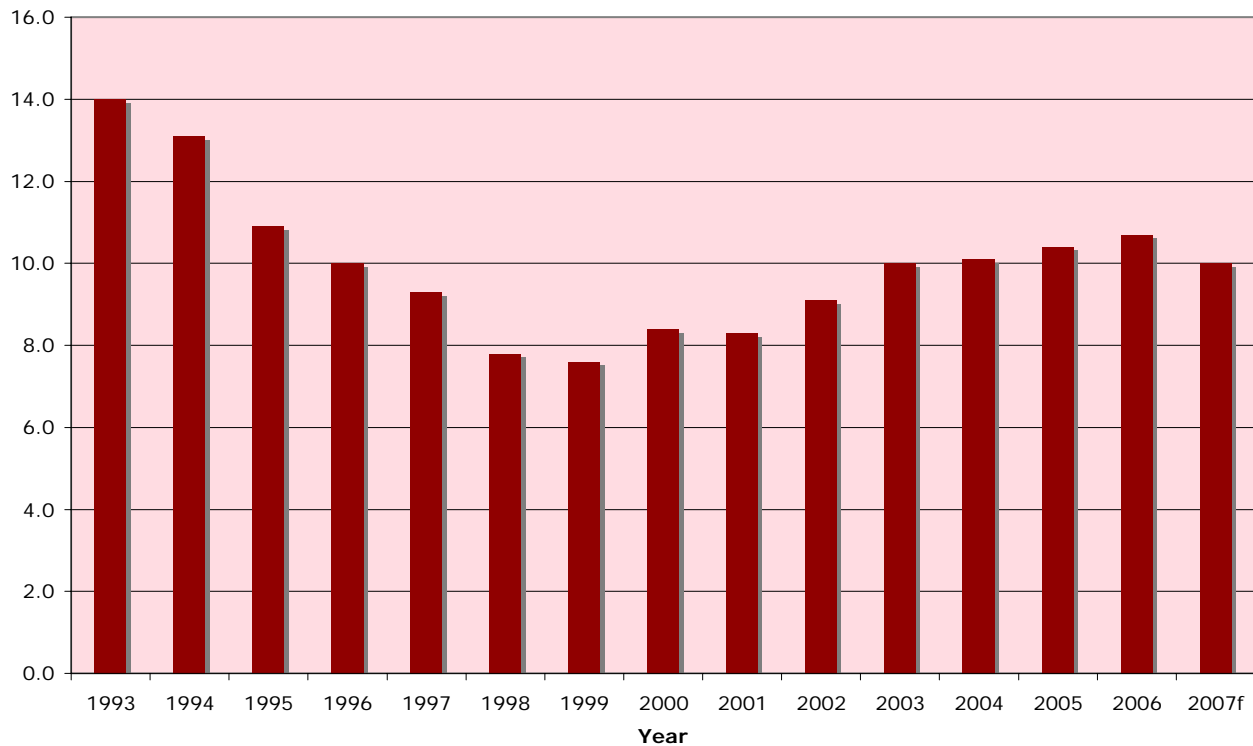
Source: World Economic Outlook, October, 2007

Finding fault

- Herb Stein's Law: If something cannot go on forever, it will stop.
- Lopsided error bands
 - it is much easier to think of things that could go wrong with these forecasts than to construct more optimistic scenarios.
 - There is a tremendous amount of uncertainty, particularly forecasting out to 2012.

China's rapid growth

China's annual real GDP growth
1993-2007, IMF WEO



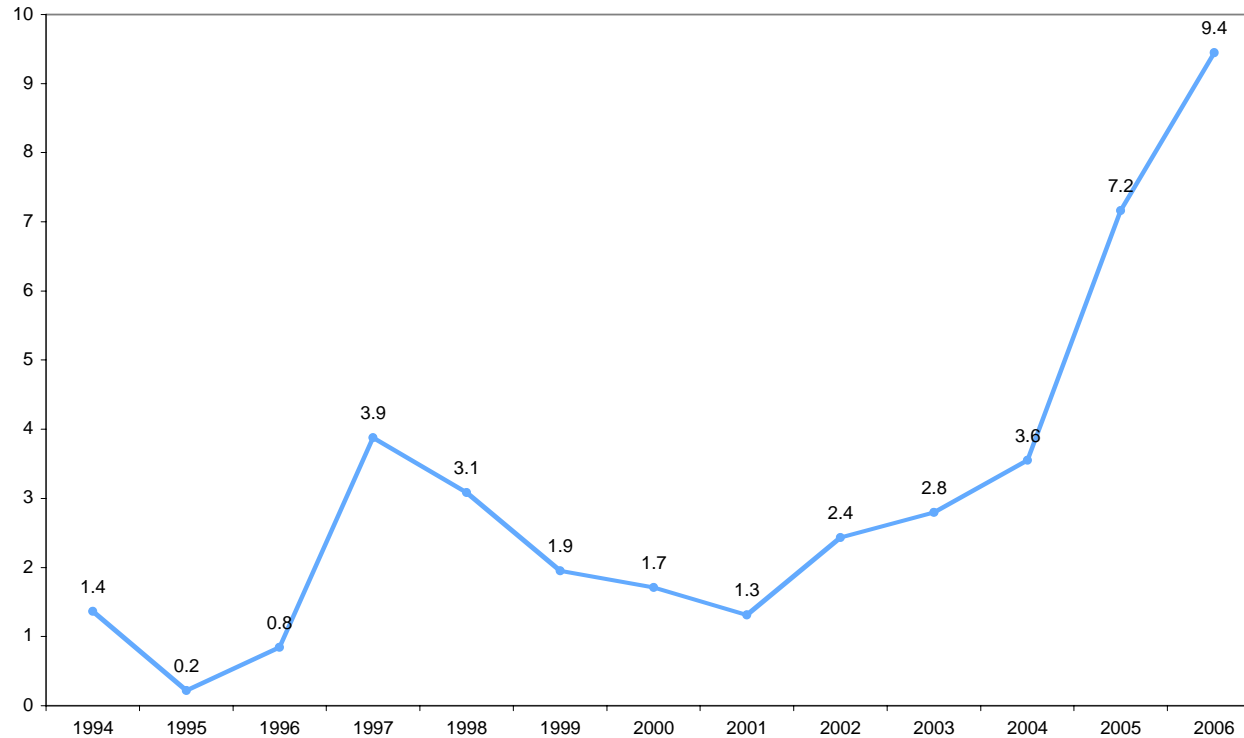
Features of Chinese growth

- Heavily dependent on investment
 - Hofman and Kuijs: On current trends, investment rises from 37 percent to almost 50 percent of GDP by 2020.
- Capital intensive, with relatively little job creation
 - He and Kuijs: From 1993-2005 employment growth averaged 1.1 percent per annum.
 - Unsurprising with financial repression
- Heavily dependent on international demand and foreign capital

China's external imbalance

China's global current-account balance (as a percent of GDP), 1994-2006

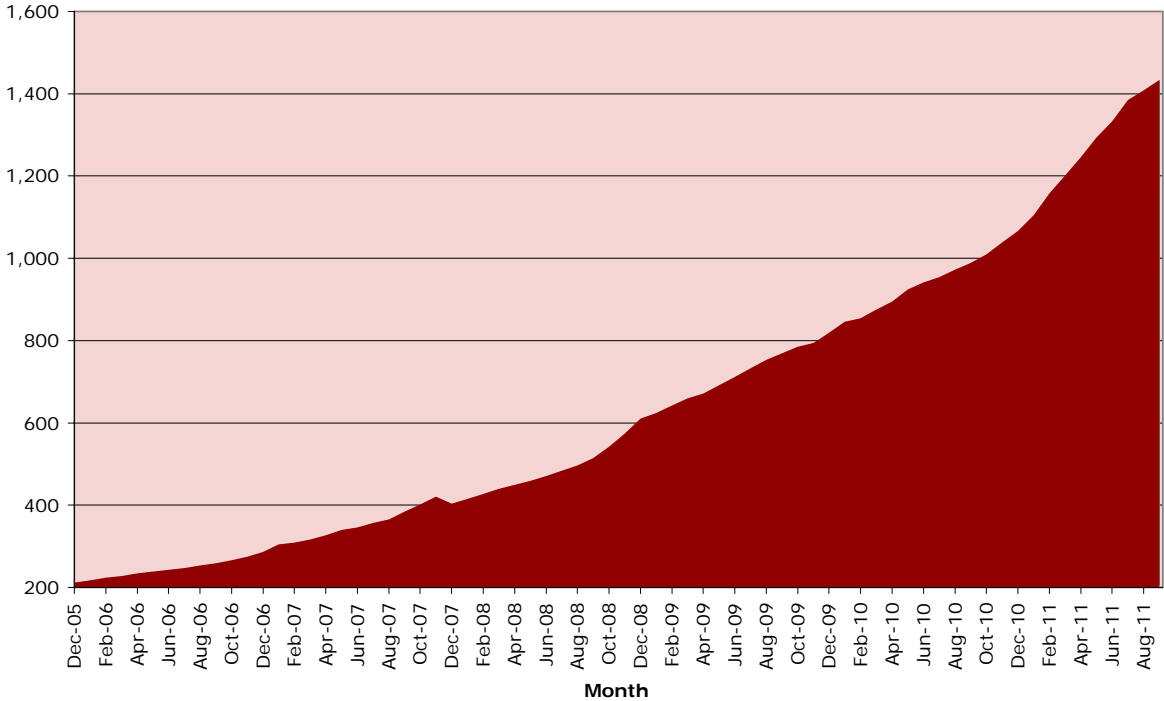
percent



Source: China State Administration of Foreign Exchange.

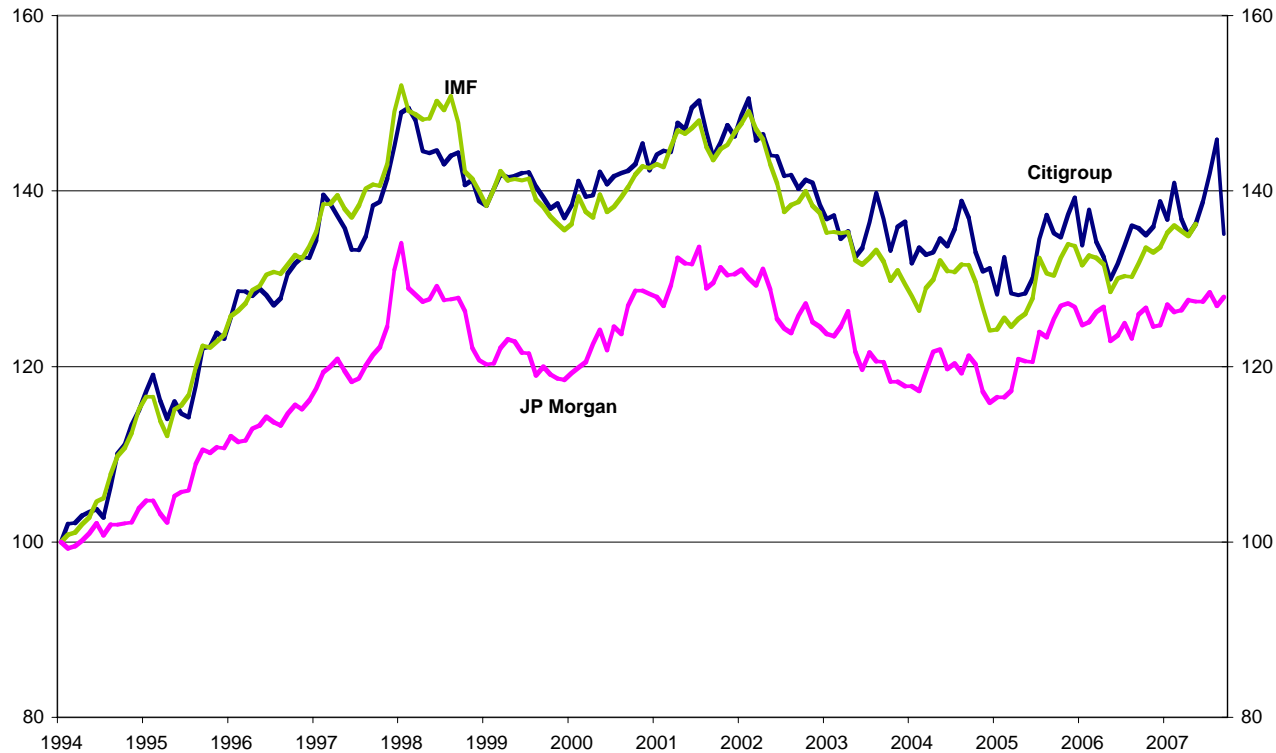
China's mounting reserves

Chinese Foreign Exchange Reserves
Source: People's Bank of China



China's exchange rate

Real effective exchange rate of the renminbi, January 1994–September 2007
index (January 1994 = 100)



Source: JP Morgan, Citigroup, and IMF.

My mounting reservations

- Buildup of foreign exchange reserves is unsustainable.
 - Banking system pressure from sterilization
 - Double cost to adjustment: interest rate rise would drive down price of bonds; currency appreciation would cut RMB value
 - Future costs mounting at an accelerating rate, including domestic adjustment costs
- What is happening with Chinese inflation?
 - Is it just the pigs? Price increases concentrated in food sector
 - Other concerns: rising global commodity costs, real estate and stock market booms
 - Administrative restrictions on price increases

...and more reservations

- The world trading system is shaky.
 - Given exchange rate movements, Europe has joined the United States in a chorus of discontent.
 - Doha, in an optimistic reading, has been put in cold storage
- How will China address rule of law concerns and corruption?
 - Product quality episodes illustrated potential costs of failure
 - Rule of law concerns could limit the development benefits of investment
 - Foreign investors have been treated as a privileged class. If that continues, there is a potential for unrest. If it stops, there is a potential for exodus.

...and still more reservations

- How will China deal with soaring environmental costs?
 - Linked to fundamental issues on rule of law
 - Problems such as water threaten near-term crises.
 - Responding will be costly.
- What about Taiwan?
 - A conflict could have devastating effects on China's tight linkages into globally distributed production
- Looming demographic concerns