



China's Ongoing Economic Transformation

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China in 2009

- 2nd largest economy in the world
- 3rd largest trading country
- Largest recipient of FDI
- Major creditor (\$US 2.2 trillion in reserves)
- But, per capita income of a low “middle” income country
 - \$US 3,250 (2008)
 - ~\$US 8,000 in PPP (2008)



Several Big Questions?

- What have been the sources of this growth?
- How long can the high growth be sustained? Where are the constraints?
- Can the rising expectations of an emerging middle class be met?
- How does China deal with the problem of a high and rising inequality?



Several Keys to China's Success

- Policy of domestic market and institutional reform combined with economic openness
 - Facilitated transfer of technology and know-how
 - Increased competition
 - Enabled reallocation of capital and labor
 - Improved governance
- A reformist political economy
 - Decentralization
 - Political competition
 - Emerging consensus on the priority of growth



Sources of Growth to Now

Extensive margin (55-60%)

- Expansion in the labor force
- High rates of investment → increases in capital per worker
- Rising skill levels of the workforce



Sources of Growth to Now

Intensive margin: Rising Productivity (40-45%)

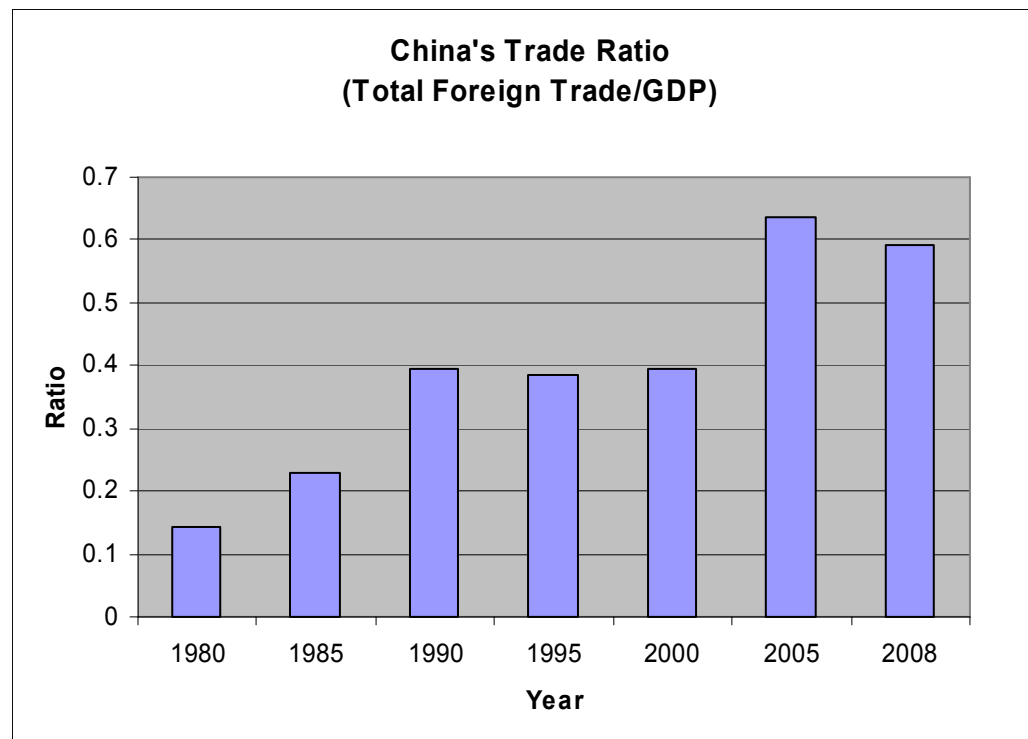
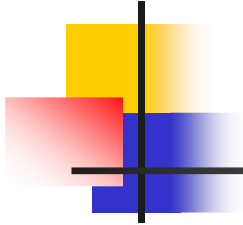
- Reallocation from low to high productivity sectors
 - Agriculture to non-agriculture
 - State to non-state
- Within-sector increases in productivity
 - Agriculture (6.2% per annum)
 - Mfg (5.0%)
 - Services (1.2%)



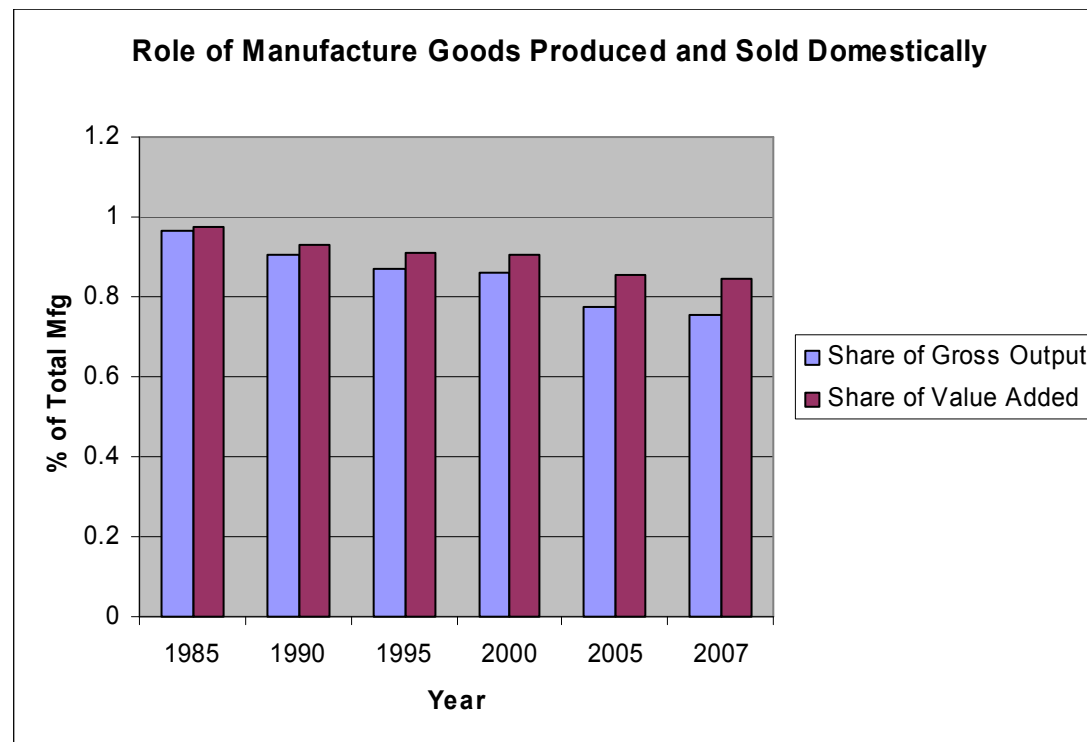
Sources of growth in the future?

- Extensive margin?
 - Returns largely exhausted
 - Investment share of GDP already exceeds 40 percent, and will likely fall over time
 - Size of the labor force will peak in less than 10 years
- Intensive margin?
 - Key to future growth
 - Linked to upgrading of capabilities, competitive pressures on firms to invest in R&D and innovate, and entry/exit
 - Constrained by:
 - Continued inefficiency and biases in the financial sector
 - Industrial strategy in key sectors promoting China's counterparts to Japan's *keiretsu* and Korea's *chaebols*

How Important Is China's Foreign Trade?



The Forgotten Domestic Economy





China and the Global Wheel Loader Market

2006 Unit Sales



2/3 of WW unit sales



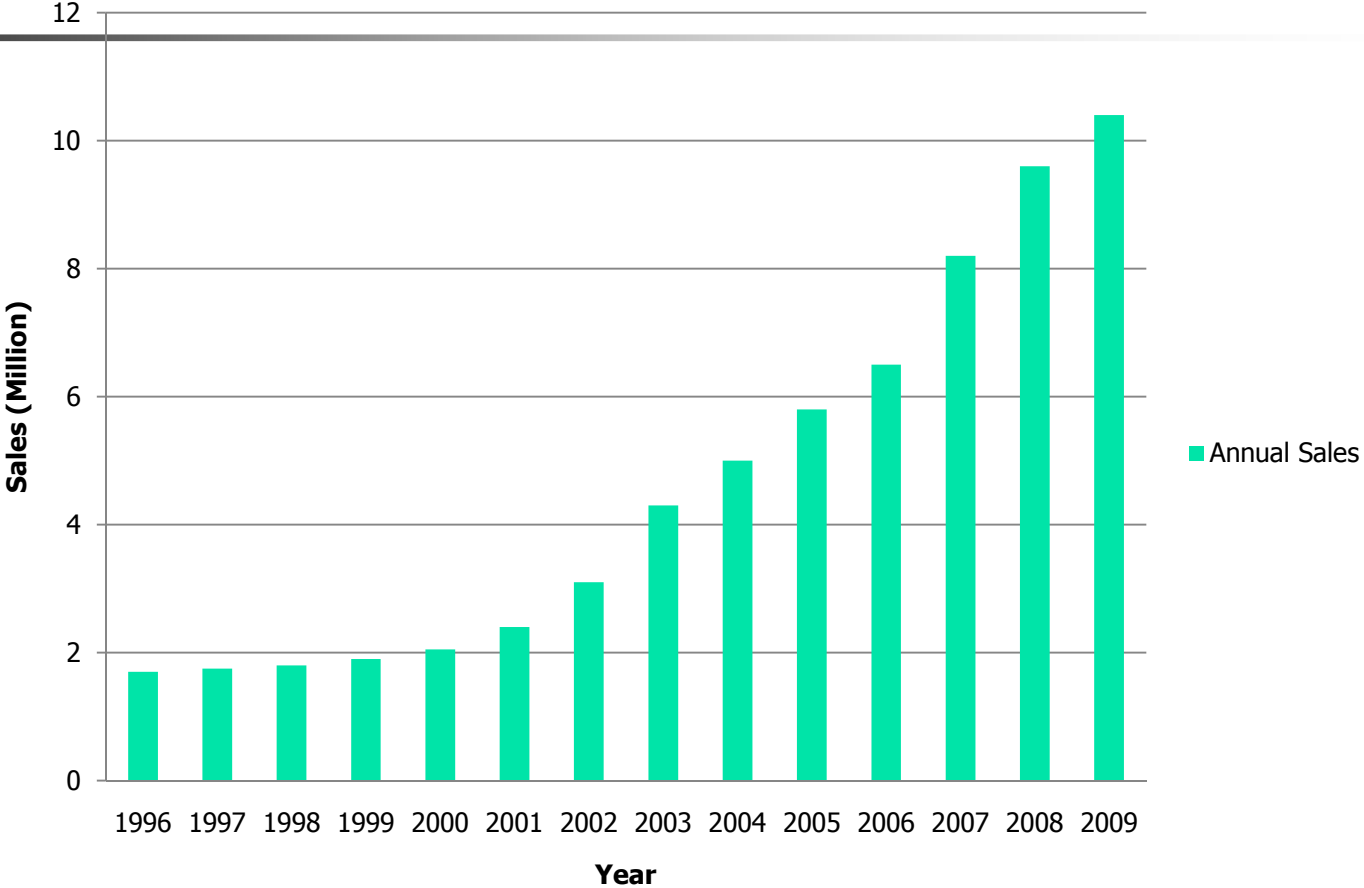
2006 \$\$ Sales



1/3 of WW \$\$ sales



Growth of Chinese Auto Market





Who is Capturing the Domestic Market in Manufacturing?

Year	Size of Domestic Market	Chinese Firms	Foreign Firms	Imports
	Trillion RMB	%	%	%
1995	4.7	68.3	13.3	18.4
2004	16.1	59	21.8	19.1

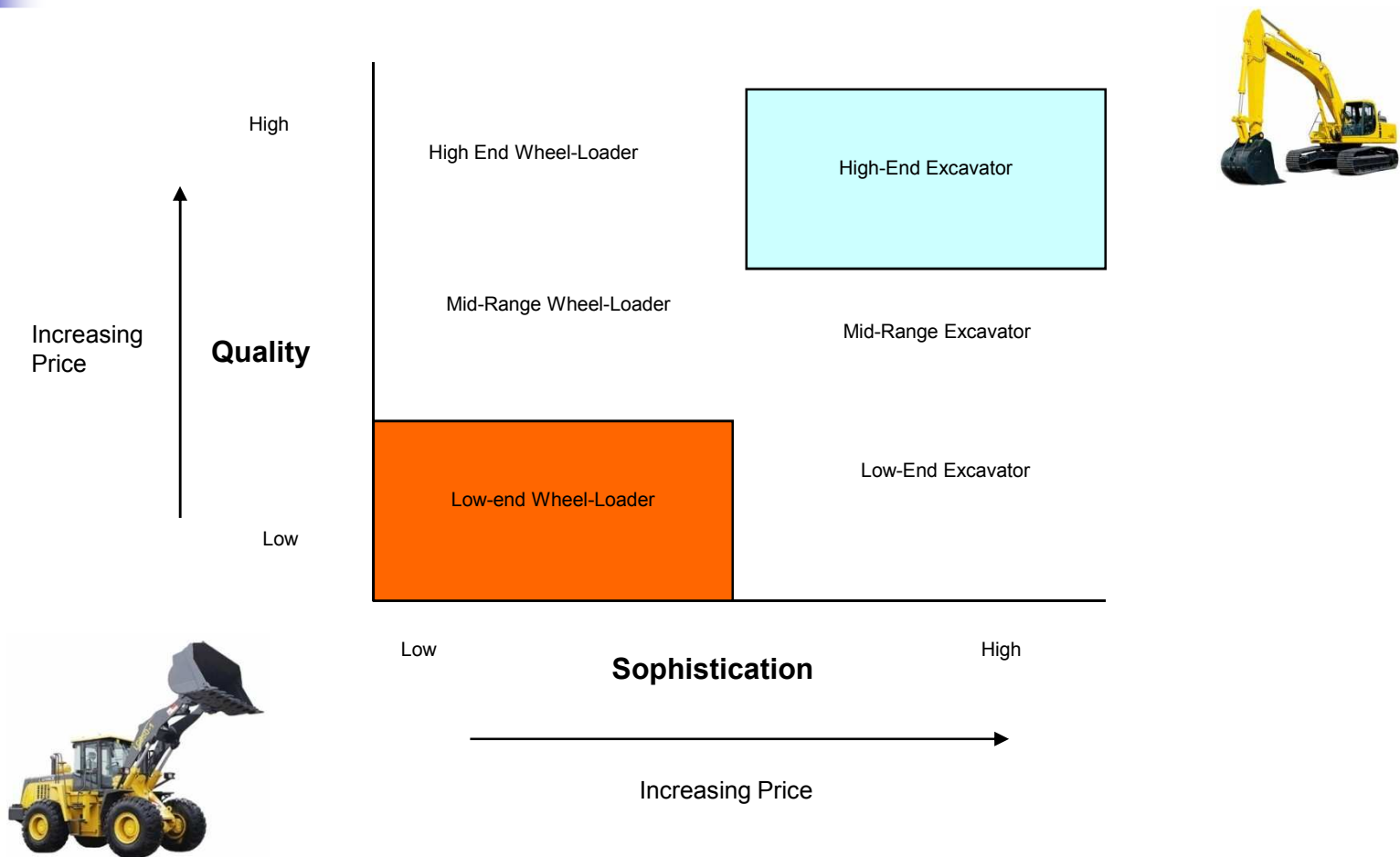


Heterogeneity Across Sectors

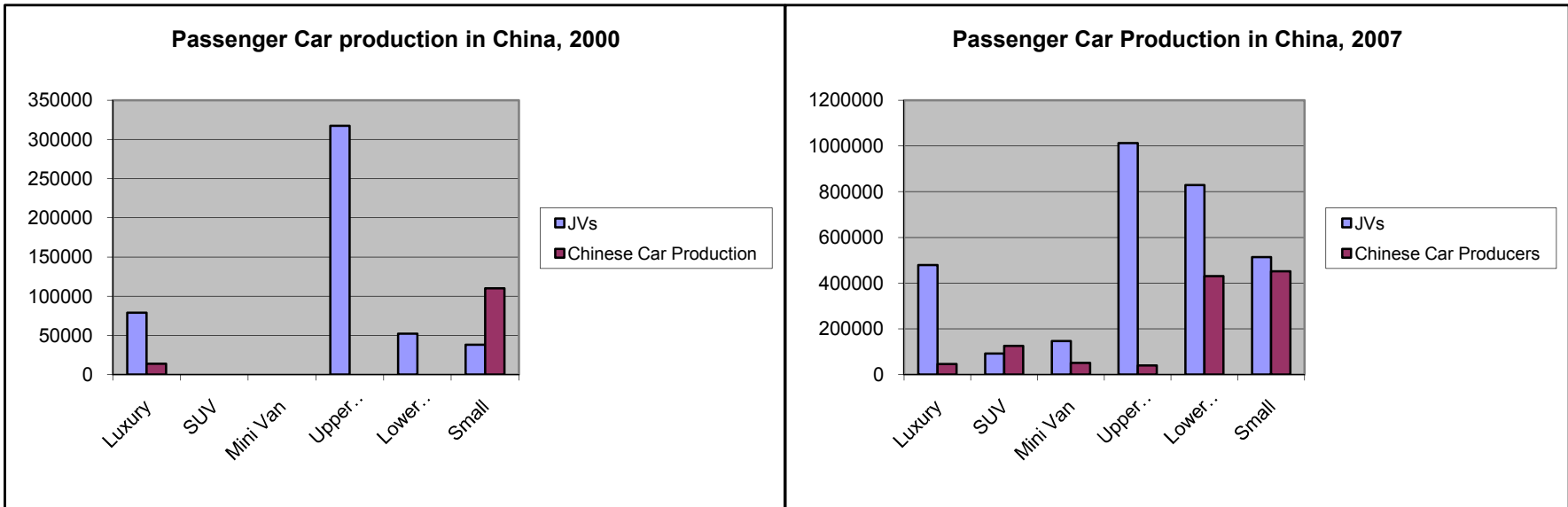
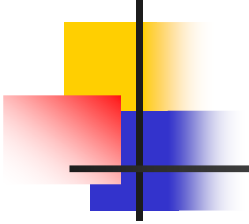
Market Share of FIEs (Percent)	Percentage of All Sectors	Illustrative Examples
0-5	14.5	Chemical fertilizers; optical instruments; metallurgy equipment; lead and zinc smelting; irrigation equipment
5-15	28.1	Spinning and weaving; machine tools; tractors; electric fans; transformers
15-25	22.6	Air compressors; construction equipment; paper products; optical glass; aluminum products
25-50	26.2	Apparel; motorcycles; electronic components; air conditioners; metal packing materials and containers;
50+	8.6	Vehicles; polyolefin plastics; communication terminal equipment; integrated circuits; television sets

Heterogeneity *within* Sectors

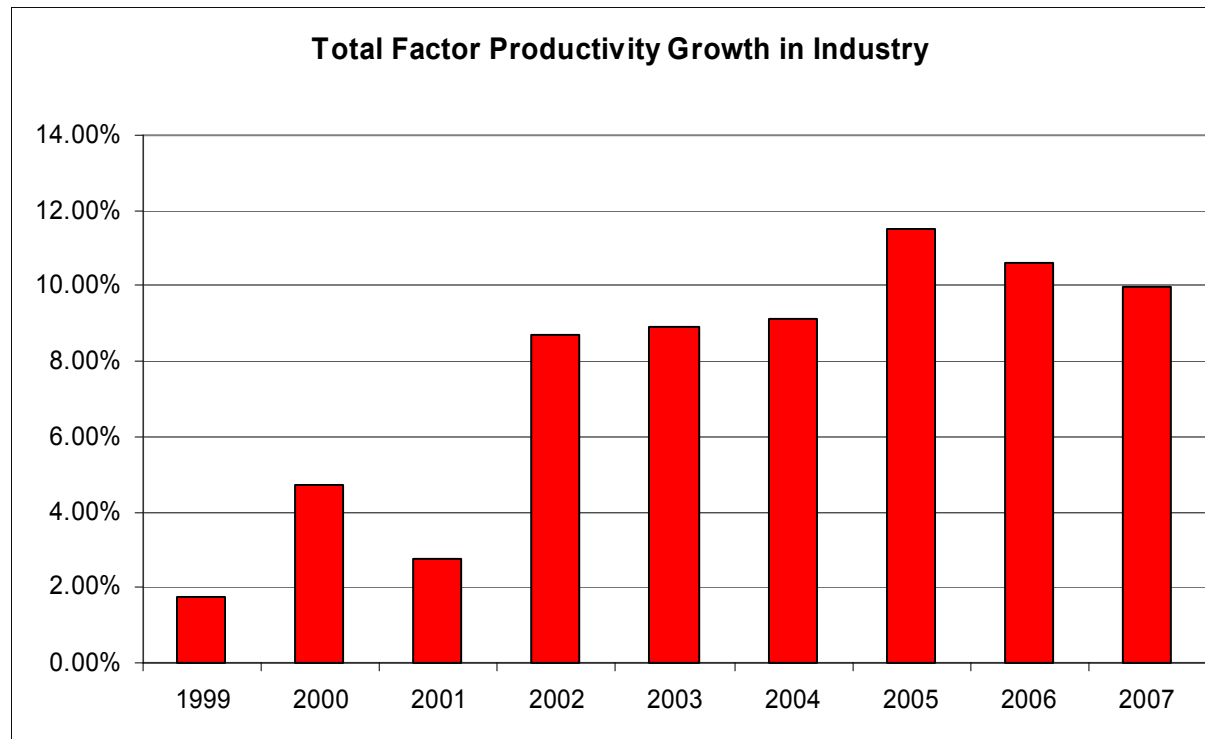
Three segments within each sector: low, medium, high



Shifting Center of Gravity in the Chinese Car Market



Manufacturing Productivity





The Dynamics of Productivity Growth

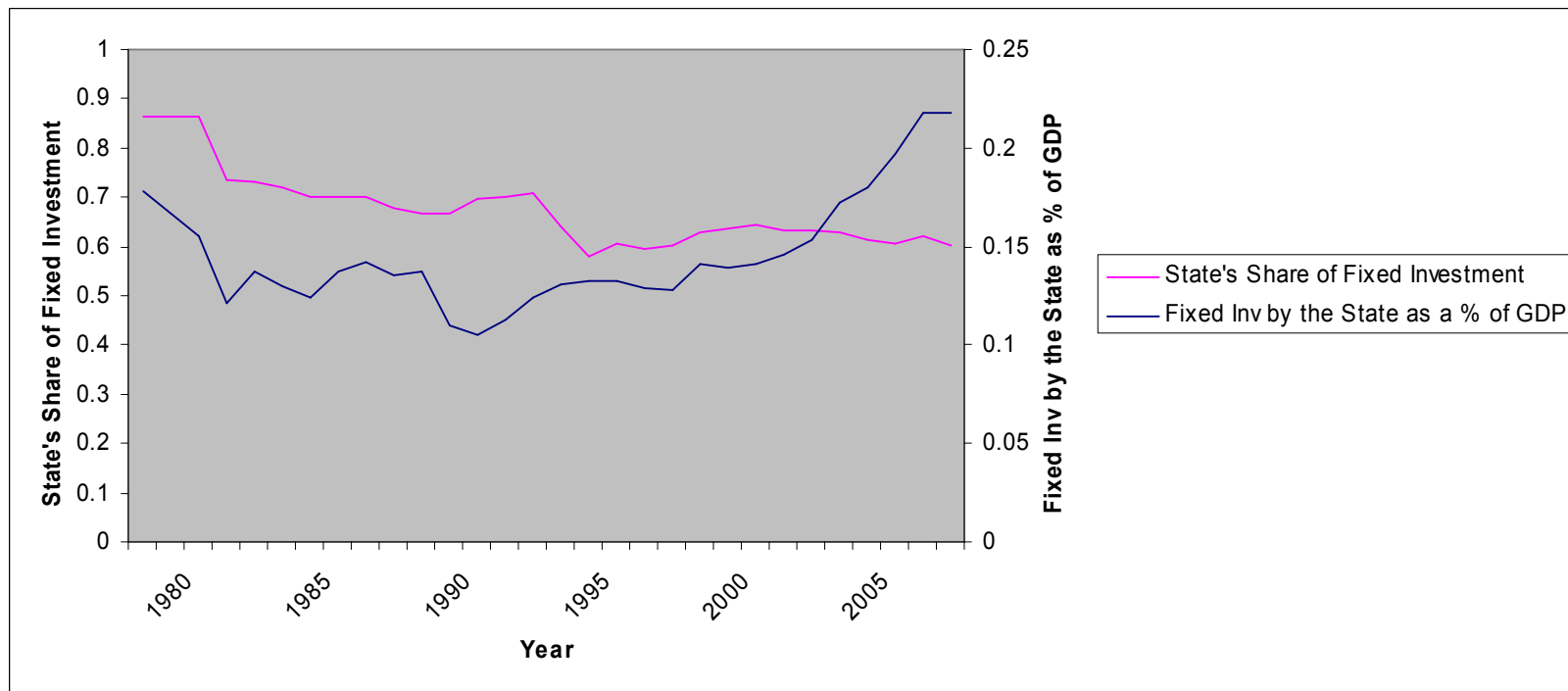
	Time Period	Contribution to Productivity Growth	
		Continuing Firms	Net Entry
China	1998-2007	33%	67%
US	1977-1987	74%	26%



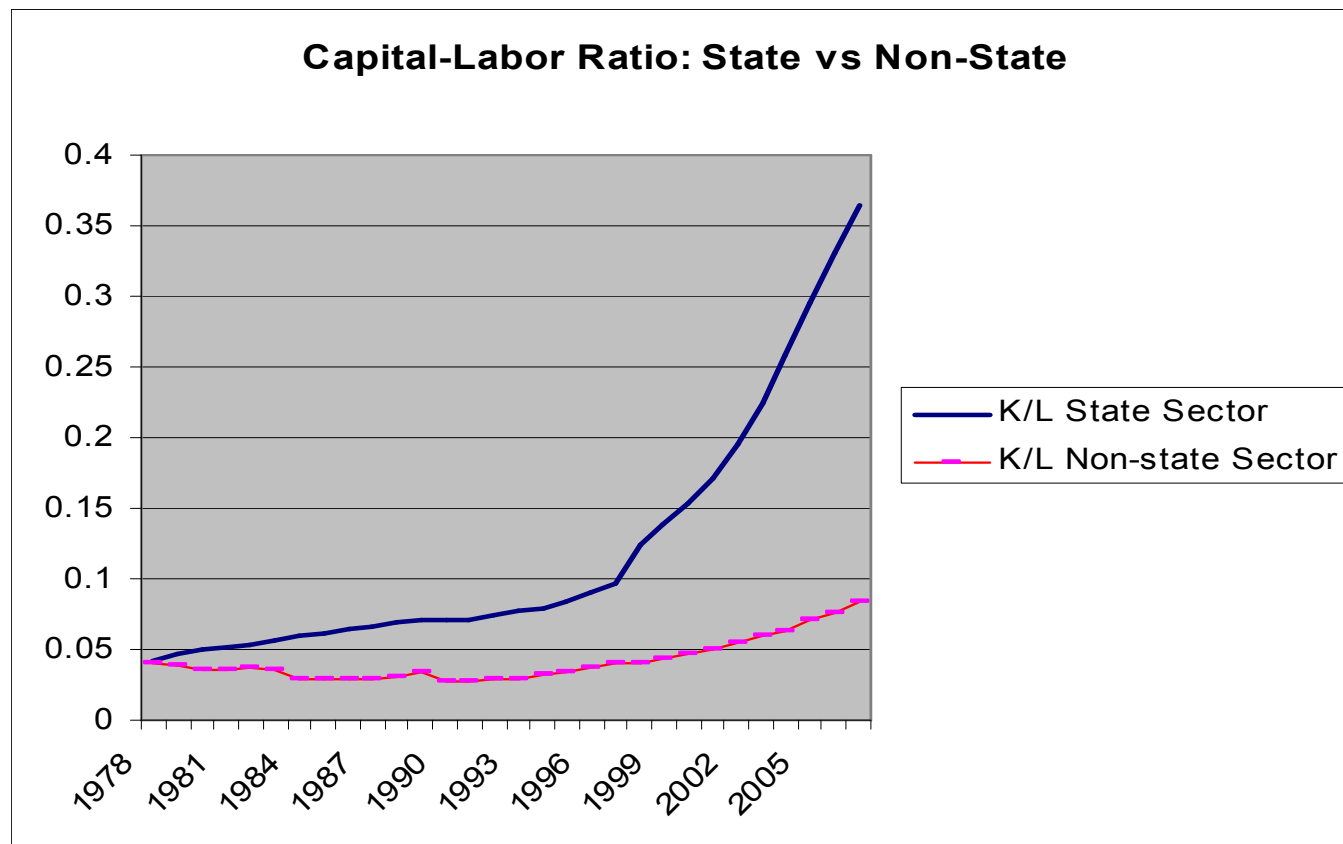
Implications

- More room for productivity growth
- Continued exit and entry, and likely acceleration in M&A activity
- Rising expenditure on R&D, as well as overseas acquisition by Chinese firms
- Increasing consolidation, but heterogeneity across sectors (state-lead vs market-lead)
- Spillover effects on global markets

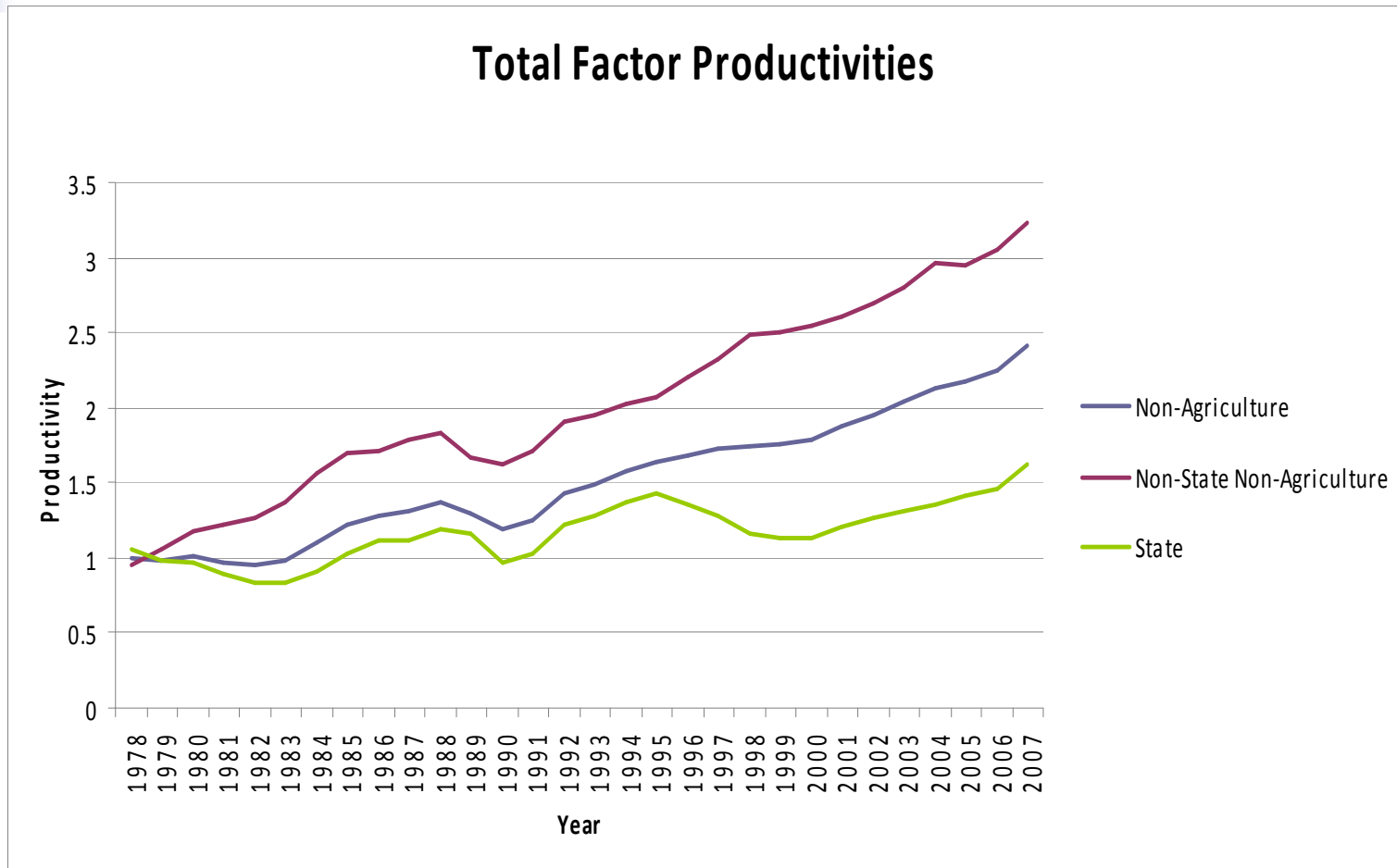
But, the Ever-present State



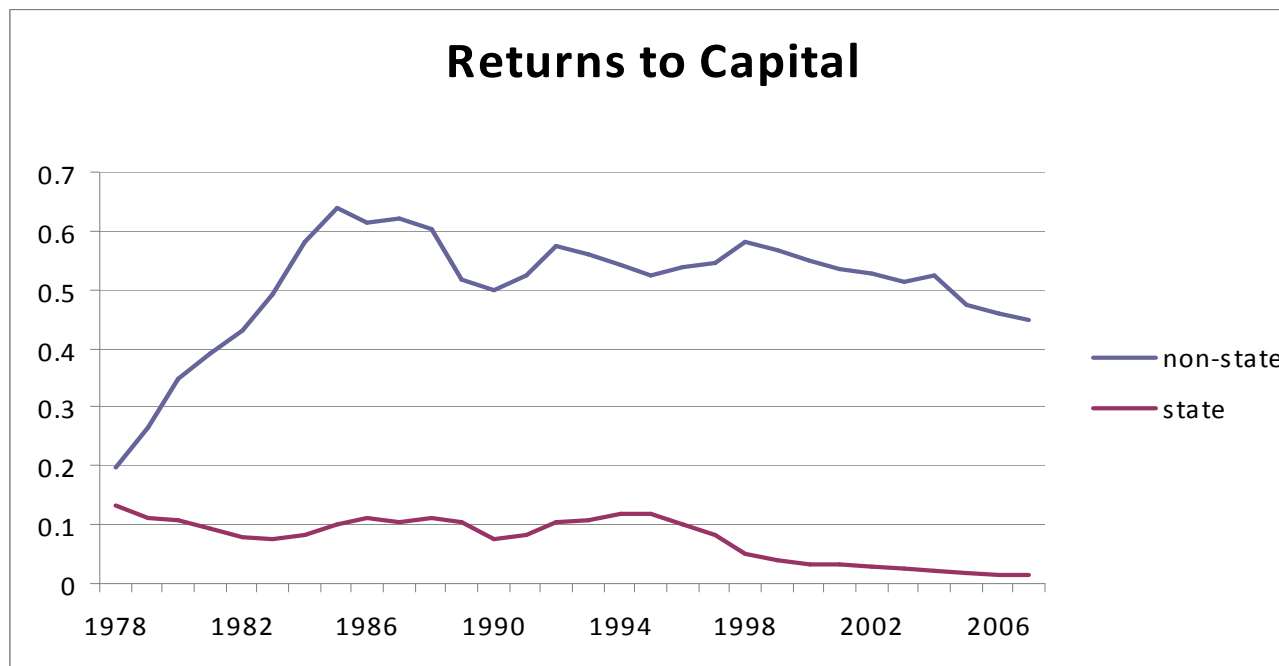
Widening Gap in Capital-Labor Ratios



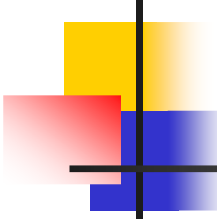
Widening Gap in Productivity



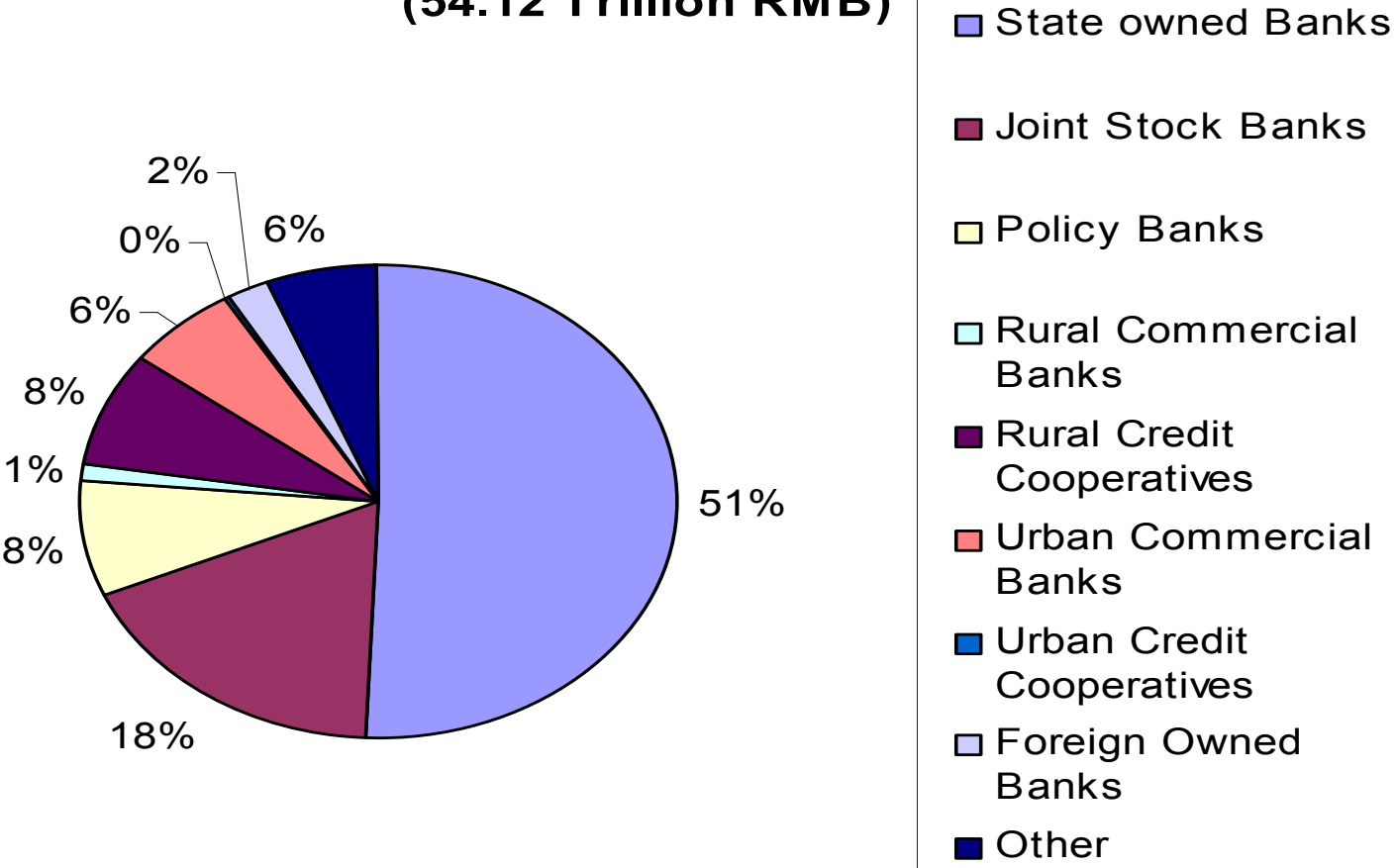
Widening Gap in Returns



China's Continuing Achilles Hill



**Assets in Chinese Banking System, 2007
(54.12 Trillion RMB)**





Sources of Funds, 2007

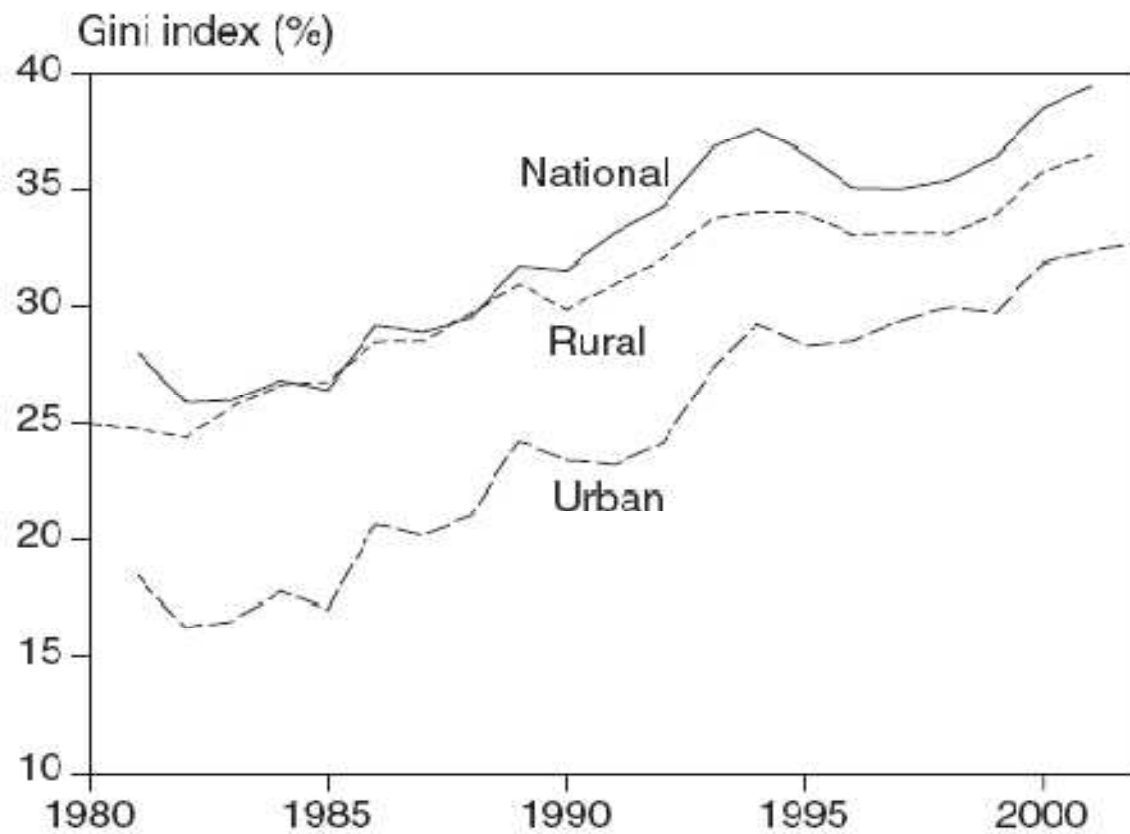
	Billion RMB	% of GDP
New Loans by Banks	3,743.3	14.9
IPOs in China	459.4	1.8
Of which: 15 Largest IPOs	404.6	1.6
10 Largest	354.4	1.4
Private Foreign Equity Investment	76.8	0.2



Why Is this So Important?

- Reallocation of capital would allow same growth rate in 2007, but at GFCF's share of GDP in 1998 (32%) rather than 2007 (42%)
- Narrow differences in K/L ratio, and likely help increase demand for labor
- Take pressure off export growth as a source of demand for labor
- Because of complementarity between physical capital and skills, may help reduce rising wage inequality

China's Rising Inequality

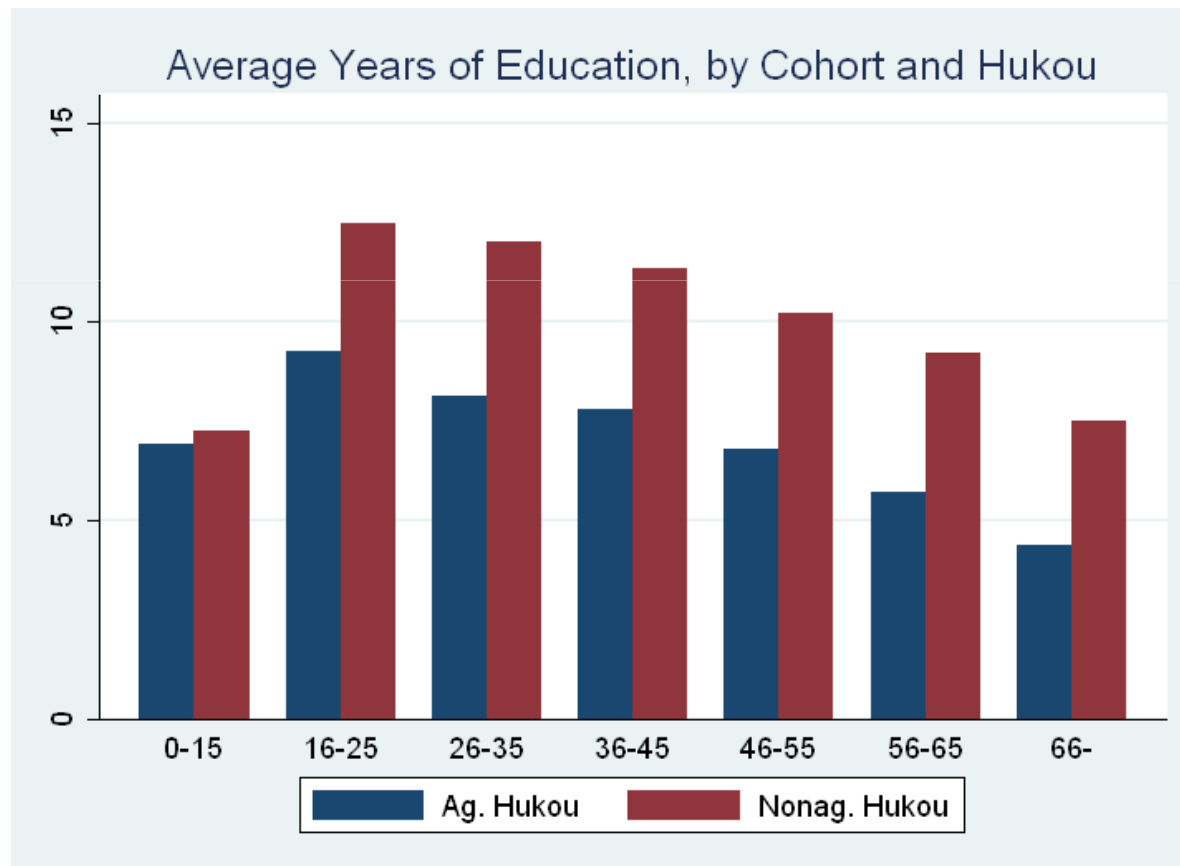


Estimated Returns to Education in Urban China

Year	Average Years Schooling	College versus High School	Technical versus High School	High School versus Junior High	Junior High versus Primary
1990	4.7	16.6	9.9	11.5	12.8
1995	6.7	24.4	12	15.3	18.9
2000	10.1	38.7	16.2	20.5	16.4

Source: Cai, Park and Zhao, 2008

China's Educational Gap





What does all of this mean?

- Issues of growth, rebalancing, and problems of inequality are linked
- Despite some progress in reforming financial system, biases persist, and state continues to grab significant portion of GDP through it
- China's current political economy makes it very difficult to eliminate these rents