China's Economy in the "Post-crisis" Period: Policy Options and Recovery Management

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Part I China's Economy Entered "Post-crisis" Period

Since 2Q09, China's economy has pulled out of recession and entered a recovery track. All the economic indicators in 3Q09 unanimously point to a strong "V-shaped" recovery, with the full-year GDP growth likely to exceed 8.5%. Meanwhile, the global economy has also bottomed out and showed signs of recovery. Therefore, we came to the conclusion that China's economy has taken the lead in entering the "post-crisis" period and thus the focus of present and future macroeconomic policy should be shifted from tackling crisis to managing recovery process.

Part II The Hopes and Fears about the "V-shaped" Recovery

As an old Chinese saying goes, "it takes less than a second to get sick but a much longer time to recover". However, this unprecedented financial tsunami "quickly comes, quickly goes". How do we understand and evaluate our response to this crisis? What impact will it have on the growth in the post-crisis period?

The government has played a key role in dealing with the crisis. The Chinese government made a U-turn in its macroeconomic policy in Q4 2008 from preventing overheating to guaranteeing economic growth, and changed accordingly the fiscal policy, monetary policy and taxation policy. The investment impulse of local government, which has long been repressed, has been able to unleash. The lending growth from the banking sector has expanded sharply after the removal of the credit quota controls, in order to compensate for the loss due to interest rate margin narrowing. In the first three quarters of 2009, the total fixed assets investment increased 33.4%, reaching RMB15 trillion; the new loans increased RMB 8.7 trillion, up 149% (yoy); the broad money supply (M2) rose 29.5%, 11.5 percentage points higher than the same period last year. Compared with the figures above, the economic fundamentals, including household consumption, non-government sector capital expenditure, external demand, corporate profits, new employment and etc, have not seen any significant improvement and are still in sluggish states.

This suggests that the year-long "V-shaped" recovery since 4Q08 is a government (including central government and local government)-led, massive credit-supported, fixed asset investment driven-recovery. The recovery doesn't have a solid foundation and lack fundamental support.

The recovery process will be slow and full of fluctuations, and require sustained attention and discretion.

The government has taken prompt actions against the crisis, restored market confidence by credit expansion, and curbed sharp economic downturn. These measures pulled China's economy out of recession and back to recovery in a short span of one year. While China's stimulus plan should be fully acknowledged, the recovery comes at a cost. It complicated post-crisis macro-management in the short term, represented by the coexistence of deflation due to insufficient end demand and overcapacity and anticipated inflation due to excess liquidity; in the medium to long term, the economic growth model of prolonged imbalance and extensive growth further deteriorated.

Part III Consolidating the Foundation for the Recovery

Post-crisis macroeconomic policies should first focus on consolidating recovery foundation. Special attention should be paid to the following indicators in economic monitoring:

1. YoY and QoQ Growth

Year-on-year growth rate is calculated over the same period of the previous year, which can avoid distortions by seasonal factors. The National Bureau of Statistics mainly releases year-on-year figures. However, quarterly statistics can reflect the economic trend more precisely when there is significant volatility in the economy. For example, in the first half of this year, GDP grew 7.1% year on year, while GDP in the second quarter rose by 17-18% (annualized) over the first quarter. As the loan growth slows down in 3Q09, GDP growth rate in 3Q09 moderates at 8.9% YoY and annualized at 9% QoQ, narrowing the gap with YoY growth. If monetary spending in 4Q09 can be further controlled, annualized YoY and QoQ growth rates are likely to converge at approximately 8.5%. This suggests that annualized YoY and QoQ growth rates overlapping on identical target figures can be used as an important indicator for monitoring the process of recovery. These target figures are closely correlated with money supply. Overemphasizing YoY but neglecting QoQ statistics will lead to misjudgment of economic situation.

2. Non-governmental Sector Capital Expenditure and Household Consumption

The direct impact of this crisis on China's economy was a decline in the external demand. The net exports' contribution to GDP has turned negative from positive. The gap resulted from the decline in the net exports need to be filled by investment and consumption. In the first three quarters of this year, investment contributed 7.3 percentage points to GDP growth while consumption contributed 4 percentage points, which was stable and slightly increased. However, net exports dragged down GDP growth by 3.6 percentage points. The government's anti-crisis stimulus plan has put the "three engines" of the economy into imbalance. Though there's no doubt that China is on track to meet the target of 8 percent GDP growth this year, the government-driven fixed assets investment can not be sustained. It is the balance of the proportion of the "three engines" that we should put more emphasis on in the recovery process, which requires the contribution of export to turn positive and that of investment to decline. The total fixed assets investment should be broken down into government investment and non-governmental sector capital expenditure. Only when non-governmental sector investment gets to rise and gradually replaces government investment, will it indicate a solid foundation for recovery. Likewise, under the total retail sales which reflect demand, government recurrent expenditure should be differentiated from household consumption, because the latter is a more precise reflection of consumer confidence and consumption demand.

3. Capacity Utilization, Inventory Changes, Capital Expenditure and Profitability

Corporate business performance is an economic fundamental, and also reflects the effects of the implementation of macroeconomic policy. The major indicators to measure business performance include capacity utilization, inventory changes, capital expenditure and profitability. The four indicators are closely interconnected. Capacity utilization and inventory changes reflect market demand and, to a considerable extent, determine corporate profits. With market demand and profits, corporations will start or increase their capital expenditure and then recruit employees. The recently released Q3 economic data suggested that industrial profits rose over Q2 with a slower decline (down 10.6%) over the same period last year, and taking into account the lower base last year, it's too early to get optimistic about any improvement in the business performance. Since the capacity utilization, inventory changes, capital expenditure data haven't been officially released, we can only make estimations by sampling. It's generally accepted that capacity utilization was still at a low level, inventory resumed growth, capital expenditure mainly concentrated in the government sector and infrastructure projects promoted in the stimulus plan, non-governmental sector capital expenditure had no much improvement so far.

4. CPI, PPI and Asset Prices

Even though GDP growth showed a "V-shaped" rebound, the CPI and PPI, which reflect consumer demand and producer demand, still remained in the negative territory. It's estimated that these two indicators will not turn positive until the end of the year. Since there's a lack of ultimate consumption and overcapacity, the two price indicators can only have moderate growth next year. At the same time, with credit expansion and low interest rates, excess liquidity is looming large. When inflation expectation resulted in a surge in investors' appetite for risk taking, the excess liquidity flooded into the stock market and real estate market with signs of asset bubbles beginning to emerge. Asset bubbles, under certain conditions, will be transmitted to commodity prices, which will bring more risks to the economic recovery and increases the complexity of macroeconomic regulation. At present, the mainstream view is that the proactive fiscal policy and the moderately easy monetary policy should not be adjusted, or else it could undermine the market confidence, interrupt the recovery process, and result in abandoned projects and non-performing loans. I feel the "V-shaped" recovery suggests that the proactive fiscal policy, at the heart of which is the stimulus plan, might have been a little bit too aggressive, and the credit supply has also greatly exceeded what is necessary to meet the target of 8 percent GDP growth. What we should do now is not to maintain the strength of the fiscal stimulus or continue the credit expansion, but to signal to the market the need for controlling the pace of credit expansion and shifting the policy objective from focusing only on maintaining growth towards focusing on both maintaining growth and managing inflation expectation. Premier Wen noted at an executive meeting of the State Council in late October that managing inflation expectation should be viewed as one of the keynotes of the macroeconomic regulation in the next phase. I think this is correct and timely. If we ignore the asset prices increases and stay inactive when asset bubbles are expanding and inflation expectation is escalating, we will misjudge the situation, which will lead to either an interruption in the recovery process or a hidden peril for post-recovery economic development.

5. Export and Tradable Industry

Export and the tradable industry[1] were hit hard by the crisis and will be the last one to recover. In this context, the recovery of China's economy will, to a large extent, depend on the recovery of the U.S. and the global economy. In the first three quarters, export fell 21.3% year on year, but MoM data has already regained growth. Port container volume dropped 7.8% YoY in the first three quarters, but MoM data has also returned to positive territory (non-seasonally adjusted). The shipping still ran at a low level. The latest projection is that export growth will turn positive by early next year, with a full year growth of 10%. Although I think this forecast might be a bit over optimistic, I agree that the economy will tend to stabilize and get back on track to growth. Once export growth turns positive, it will, marginally, make positive contribution to the GDP growth, and will also accelerate the growth of the tradable industry. As a result, the proportions of the “three engines” in the economy will tend to rebalance and the prospect of recovery will get clearer.

6. New Employment and the Urbanization in Rural Areas

As a result of the financial crisis, about 20 million migrant workers in the export processing industry in the Pearl River Delta and the Yangtze River Delta lost their jobs and returned home. The employment statistics failed to include this huge amount of laid-offs and therefore the seriousness of the employment problem has been underestimated.

Generally speaking, employment is the most lagging indicator of an economic recovery. Compared with other economies, employment has a greater impact on economy and social stability in China, mainly because: (1) China has not entered an aging society and the pressure of job creation is still considerable; (2) the social security system is far from perfect, the minimum

[1] Tradable industry is defined as the industry that is priced in the international market, namely, the trade-related industries, which, in a broad sense, include export processing industry, ocean shipping, foreign trade ports, and etc.

social insurance is not sufficient, and social stability is very sensitive to unemployment; (3) more jobs need to be generated to complete the urbanization process in rural areas. Therefore, employment is China's most important economic indicator. In the "post-crisis" period, we should pay close attention to the interactions between economic recovery on the one hand and job creation and urbanization process on the other.

Many of the indicators mentioned above have not been released as the official statistics, because, first, the statistics need to be further improved; second, China's GDP is calculated using the "output method" rather than the internationally accepted "expenditure method". According to the "expenditure method", the "three engines" of GDP are defined respectively as final consumption (including household consumption and government consumption), gross capital formation (including gross fixed asset formation and inventory changes) and net export of goods and services. We are currently using three alternative indicators: total retail sales of consumer goods, total fixed asset investment and trade balance. There are significant differences between the definitions of the two sets of indicators, the most of which are: excluding household services consumption (education, health care, self-owned housing, culture and entertainment and etc.); including land, old buildings and old equipment purchase price, which should not be counted as productive activities, in the fixed asset investment, but not including inventory changes; not including trade in services in the trade balance. These alternative indicators are subject to adjustments in practice and the indicators not included in the statistics need to be estimated by sampling. During the crisis and the recovery period, the problems and shortcomings of China's statistical system may be misleading to the macroeconomic policy. Therefore, it's quite urgent to push for the transition and improvement of the statistical system.

Part IV Liquidity Management and "Exit" of the Government Stimulus Policy

The second focus of the macroeconomic policy in the "post-crisis" period is liquidity management and discretionary "exit" of the government stimulus policy.

Now when it comes to policy adjustments, the public will fly into panic and the stock market will plummet. It's suspected that the central government's macroeconomic policy has been "hijacked" by local governments and some interest groups. One of the key features of the macroeconomic policy is expectation management rather than ex-post rectification. Certainly, the timing, the instrument and the intensity of the adjustments need to be determined prudently and the adjustments should be gradual, moderate, controllable, and not be reckless.

The "V-shaped" recovery of China's economy in 2009 is a recovery led by the government and driven by credit and investment. The fundamentals of the economy have not seen any significant changes, but the money supply, credit expansion and total investment have been far beyond what are needed to meet the 8% GDP growth target. The growth rate of M2 has almost been 30%, while it should be only 4-5 percentage points higher than the growth rate of nominal GDP under normal circumstances; the total amount of new loans will be close to 10 trillion this year, which is one-third of the outstanding loans of all financial institutions across the country as of the end of 2008. It will be difficult for investment and money supply to come down in two years. In the meantime, asset prices, taking the stock price and the real estate price for instance, have been soaring so far this year, which has decoupled with the real economy. As China's economy took the lead to recover, the appreciation pressure of RMB reemerged, as a result, foreign direct investment and international hot money will undoubtedly flood in the domestic market. All these suggest that policy adjustments and "exit" of the stimulus policy are inevitable, what really matters is just the timing and instrument. I believe that the interest rate increase should not be later than the second quarter of next year, and some administrative measures and other policy instruments could be taken before the interest rate increase, such as: controlling project approval, postponing project start-up and extending construction period, issuing central bank bills, increasing the reserve ratio for commercial banks, raising the capital adequacy ratio standard for commercial banks and etc.

The decisive bailout and effective counter-crisis measures carried out by the Chinese government have been highly appreciated by domestic and international community, but a complete counter-crisis macroeconomic policy should not only entail the determination and ability to bail out the economy, but also involve the government's flexibility to adjust policies and the arrangement to "exit" when the economy stabilizes, asset bubbles emerge and inflation expectation rises. If 2008 was when the global financial crisis broke out and 2009 is when the governments around the globe bail out the markets, then 2010 will be when the governments start to "exit". China's economic recovery is 6-month ahead of the international community, thus it's expected that the Chinese government will continue its exceptional performance in controlling liquidity and arranging "exit" plan rather than making a last-minute U-turn as it did in the fourth quarter of 2008.

Part V Sustainable Economic Growth via Structural Adjustment and Transformation of Growth Pattern

The third focus of the macroeconomic policy in the "post-crisis" period is to adjust economic structure and to transform the recovery into sustainable development.

The global financial crisis has sparked the criticism about the U.S. laissez-faire financial regulatory policy and the challenges about the global financial regime and monetary system, but the root cause of the crisis rests with the structural imbalance characterized by the over-reliance on consumption, as represented by the U.S., and the over-reliance on export, as represented by China, in the globalization process over the past decade. In this sense, this crisis is a fluctuation caused by the structural imbalance rather than the usual cyclical fluctuation[2] caused by imbalance in supply and demand. The global economy will not return to the pre-crisis situation after the crisis, but arrive at a new equilibrium. Therefore, the recovery process should be a "rebalancing" process.

[2] Refer to "The New Understanding of the Financial Crisis", Qin Xiao, Caijing Magazine, No.5, 2009.

The so-called "rebalancing" involves both supply and demand side adjustment. On the supply side, the most acute problem is overcapacity. Some industries have already encountered overcapacity problem before the crisis, and the problem was even exacerbated by the government's industrial revitalization policy to counter the crisis. After the crisis, with a falling external demand and a moderate decline in China's economic growth, the overcapacity problem is getting even more serious. In the "post-crisis" period, the economy has already stabilized, thus the emphasis of the policy should be shifted from revitalization to adjustment. First, new projects to be launched in these industries should be strictly controlled; and second, bankruptcy- and merger-related policies and services should be put in place. The developed economies have experienced a painful "deleveraging" process in the crisis; on the other hand, it's imperative for China to start planning for "de-capacity" as soon as possible. Another problem on the supply side is industrial structure optimization, which mainly includes: First, to further increase the proportion of service industry in the national economy in order to improve employment and income; second, to promote industrial upgrading with a view to raising labor productivity and international competitiveness; Third, to strengthen energy saving and emission reduction efforts to make economic growth sustainable.

The above will definitely affect the pace of China's GDP growth. The total GDP and its growth rate are mainly subject to two factors: market demand and "potential output capacity"[3]. In the "rebalancing" process, the decline in external demand is structural, while China's "potential output capacity" should take full account of factor prices (including exchange rate) distortion, the environmental sustainability and the constraints on energy and raw material supply. In short, in the medium term, the reasonable range for China's GDP growth trend should be around 7.5-8.5%. Even if no adjustment is made to resolve overcapacity, the GDP growth can not and should not return to the pre-crisis 10-12% level.

On the demand side, the two major problems are the slow growth of farmers' income and the decline in the proportion of income on labor in the initial distribution. The government's support for rural and agriculture and China's urbanization have to a large extent improved the living standards of farmers, but the gap between urban and rural areas has been widening. I think the key reasons are: first, the "urban-rural dual system" sets systemic barrier for farmers to become urban residents, and migrant workers and their families can not equally enjoy the public services provided by the government to urban residents, such as: education, health care, housing and etc.; second, farmers can not get their fair share of the benefits generated from land in the urbanization process. The dual system which distinguishes between urban and rural residents should be changed and the policy that allows farmers to share the benefits generated from rural land transfer and development should be put in place, which will increase farmers' income significantly and quickly.

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[3] "Potential output capacity" is defined as the maximum output level of an economy, given the existing resources, technology and production capacity, and under the premise of not causing inflation, which is also known as "potential aggregate supply".

The decline in the proportion of income on labor in the initial distribution is because: first, the industry policy has long tilted towards the heavy industry that has a higher organic composition and towards capital in order to attract foreign investment, the motivation of which is local governments' one-sided pursuit of GDP growth. The transformation of the economic growth pattern and the structure adjustment should fully take into account the positive effects of economic growth on increasing employment and improving income distribution; second, national wealth has been over-concentrated in the hands of the government and the public can not share the massive wealth, assets and earnings of the state-owned enterprises. The government-owned wealth should be transferred to the general public in an orderly, effective and fair manner, thereby enhancing the assets income of the public, supplementing the social insurance of the public and improving the consumption of the public, while strengthening the government's ability to provide public goods.

It needs to be elaborated that Keynes' short-period analysis framework is applied in the above analysis of supply and demand structural readjustment, that is, consumption, investment and net exports are regarded as the "three engines" for economic growth. Strictly speaking, A Modified Solow Approach with Cobb-Douglas Production Function should be applied to analyze long-run economic growth. That is,

Total production= total factor productivityA. Capitar$^{\alpha}$ .Labour $^{1-\alpha}$

The two approaches differ not only in short-run or long-run implications, but more importantly in the perspectives for economic growth sources. Based on the former, macroeconomic policies will focus on demand, especially investment demand; while the latter puts more stress on supply, especially technological upgrading. Wu Jinglian and Qian Yingyi et al. have made special discussion on this subject.[4]

Part VI: Re-launching the Reform Agenda

At the beginning of this century, China lived through the Asian Financial Crisis, accessed to the WTO, and has been on the track of fast economic growth in the context of global economic integration. However, it was in this very period that the pace of reform has significantly slowed down and the economy has entered a "reform dormancy" period, the reason for which was lack of motivation and consensus. But the problems and conflicts have been accumulating and the structure imbalance has been escalating, and finally, all these blew up in the crisis. Crisis is the catalyst of reform. All of China's reforms over the past three decades were associated with crises, thus it is reasonable to expect this unprecedented global financial crisis will reinvigorate China's reform.

[4] Wu Jinglian: Guaranteed 8% Growth without Income Growth for Ordinary People, Net Ease Caijing, 4 December, 2009.

Awakening the "reform dormancy" requires not only motivation but a widely accepted "reform agenda". This agenda should include: the diagnosis of the problems and the solution to the problems. The essence of the so-called "solution" is whether or not to unswervingly push forward the market-oriented reforms. In the so-called "socialist market economy", market economy is the "foundation" and socialism is the "characteristic". In this sense, the "socialist market economy" is the market economy that places more emphasis on fairness, justice and harmony. Any deviation from this basic understanding will mislead China to retrogression and wrong track.

I believe that the main content of the "reform agenda" should consist of:

1. Transforming the government's functions

The government's major economic functions in a market economy should include: first, maintaining credibility and order of the market and providing systemic and legal protection for market activities; second, implementing the secondary distribution through transfer payment and improving social equity; third, maintaining the balance of payment and stability of exchange rate; fourth, applying macro-economic policies to counter the economic cycle and prevent inflation or deflation to maintain a steady economic growth and achieve full employment. In developing and transitional countries, the government also needs to discharge the duty of revitalizing the economy and reforming the system, but as the market matures and the transition progresses, the role of government should be adjusted accordingly.

When China began its transition from a planned economy to market economy thirty years ago, it didn't have a clear idea of positioning government's economic function in the market mechanism, or it failed to get a widely accepted mode. This is because: first, the understanding of the market mechanism was insufficient at that time; second, a powerful, comprehensive government was required in the top-down reform process; third, there's a misunderstanding of Japan's "MITI" mode and South Korea's "Cheongwadae" mode. Due to path dependence, China has since then been locked into the road of "developmentalist government"[5], namely, the government leads the economy, controls economic resources and participates in economic activities directly. In the subsequent development process, the shortcomings of this mode have gradually emerged, mainly including: the combination of power and capital has led to corruption and a large number of rent-seeking activities; the cumbersome bureaucracy and excessive intervention and control have significantly increased the transaction costs of the market operation and stifled entrepreneurs' innovative spirit, resulting in a loss of efficiency and profitability; the government's direct control over economic resources and participation in market transactions have confused the different roles of government and enterprises, undermining the rule of fair competition; the deviation of the management focus and the misallocation of resources have

[5] Refer to "From Authoritarianism to Democracy", Wu Jinglian, Masahiko Aoki, CITIC Publishing House, October 2008.

weakened the government's ability to provide public goods. This phenomenon has triggered contemplation and challenges, and criticism has escalated, thus the reform of the government has become a subject of discussion and concern. Over the past two decades, the government has enforced several major reforms, but the focus of the reforms was not to transform the government's functions but to improve the administrative efficiency. The reason why it has been difficult to enforce the reforms was there have been not only limitations of understanding, but impediments by interest groups as well.

After entering the new century, China's economy has been growing rapidly, thus "China myth" and "China mode" has become the "New Left" scholars' favorite topic. They greatly appreciated China's government-led-economy mode and criticized the mainstream economics and the mode adopted by developed economies. With the advent of the financial crisis, it's well received that the Chinese government has demonstrated its ability and efficiency to bail out the market and China's economy has taken the lead to recover, and the Chinese government also felt proud of having been able to "concentrate all the resources on big issues". It seems not only that China's "developmentalist government" mode does not need any reform, but it has become the paradigm for developed economies to follow.

I don't think that the story of China's economic growth should be interpreted as a success of the "developmentalist government" mode, on the contrary, its' required to make sweeping changes in the government's functions to realize the sustainable development of China's economy. That is to say, it should switch from a government-led economy to a market-led economy and from a government focusing on economic construction to a government focusing on providing public goods[6]. The government's bailout is just a makeshift to counter the financial crisis; it does not mean that there are any new changes in the boundary between the government and the market. Certainly, China and developed countries have different national conditions and different cultures, and there are wide gaps between China' level of development and those of developed countries, thus we can not copy their modes or experience indiscriminately and should also be critical about their problems. But the fundamentals and principles of market mechanism are common. Only by following these fundamentals and principles in line with China's reality to push forward the transformation of the government's functions can China get out of the "locked-in" state in the reform process and get on the road to a market mechanism which is more mature, more standardized and more innovative.

2. Timely relaxing and deregulating the controls on factor prices, pushing forward the market-oriented pricing mechanism of public utilities

One important issue remains in China's market-oriented reform is the price controls on factors and utilities.

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[6] Refer to "Economy Transformation and Changes in the Government's Economic Functions, Qin Xiao, "China Economic Times", January 16-17, 2006.

Factors include: land, energy, capital and raw materials

i. Land

In the process of industrialization and urbanization, local governments have acquired a great deal of land (hereinafter defined as land used for construction in rural areas) from farmers and realized huge returns. As land acquisition is the government's administrative behavior rather than market transaction, the acquisition price is just a kind of compensation and can not truly reflect the market value of the land. This makes sense from legal perspective for public projects but is unfair for commercial projects. Of course, the value of land is, to a large extent, influenced by the government's planning, thus the value added should be shared amongst the related parties. In the land transfer process, commercial projects adopt the procedure of "public bidding, auctions and listed land grants". It looks as if it's a market behavior, but since the government is the single seller of land and controls the size of land supply, the price of land is controllable. It is only where many buyers and sellers independent of each other conduct transactions frequently that the term market can be applied and the equilibrium price can be discovered.

The current land system has given rise to a series of problems: local government fiscal position relies on land and property-related incomes[7]; housing price has been rocketing; the housing shortage of low-income groups has not been resolved or improved; farmers have lost their lands and deserved benefits.

I believe that one option is to formulate policies that require local governments to disclose land stock, and new land supply each year. Part of the profit from land transfer should be paid back to farmers through transfer payment. The taxes and fees received by the government from land development should be primarily used to acquire additional land and build "low-rent houses". Another option is to distinguish between public projects and non-public projects, the former may be acquired by the government from farmers while the latter negotiated directly between farmers and developers and the government can levy taxes and fees on the value added from planning and development.

ii. Energy

As the economy's demand for energy (hereinafter mainly referring to oil) increases, China's dependence on imported crude oil has exceeded 50%. Currently, the major reason why the government imposes controls on the prices of crude oil and refined oil is that it's concerned that

[7] According to the author's investigation, excluding land transfer profit, only the taxes and fees gained by the government from real estate development and sales are usually not less than the net profit obtained by developers. Taking into account the land transfer profit (profit for the government and expenditure for developers), the government's profit will be greatly higher than that of developers. According to incomplete statistics, the income of the local governments in the coastal areas gained from land transfer and land development accounts for more than 50% of the government finance.

the fluctuations in the international crude oil price may impact people's livelihood. The major causes for the sharp fluctuations in international crude oil price in recent years involves: first, China, India and other emerging economies have been growing rapidly, resulting in a temporary imbalance between supply and demand; second, crude oil futures, as a LME traded commodity futures, attracted large amounts of money to speculate; third, a weakening dollar drove up the crude oil price which is denominated in dollar. In this case, it's necessary to impose some control on the crude oil price, but price control will undoubtedly give rise to distortion in the supply and demand and misallocation of resources, which is not a long-term solution. China's economy's over-reliance on export and investment is also related to the underestimated energy prices.

The debates about the reform of the energy price control have never stopped. When the economy was overheating, it's feared that the reform would cause inflation through cost pass-through; when the economy was in recession, it's feared that the reform would increase the burden on businesses and households, undermining investment and consumption. Thus, this issue has been put on the shelf for quite a long time. I think that the re-launched "reform agenda" should include the reform of energy pricing policy and make it clear that the objective of the reform is to deregulate control and to be consistent with the international market prices and the reform can be gradual. Clarifying the objective of the reform will make the market form a more definite expectation, which is conducive to the implementation of the reform.

iii. Capital

Over the past two decades, the RMB exchange rate regime has undergone two major reforms, one was the opening of the current accounts (mainly trade accounts) in 1996 and another was changing the exchange rate regime from pegged to the U.S. dollar to a "managed floating exchange rate regime" in 2005, and the RMB exchange rate was adjusted accordingly. Under this regime, the RMB had appreciated about 6 percent per year until the end of 2008. With the advent of the global financial crisis in 2009, the RMB appreciation has stopped and the so-called "managed floating exchange rate regime" has existed in name only. That is to say, the RMB exchange rate regime has imperceptibly gone back to the original regime pegged to the U.S. dollar before the reform in 2005. The financial crisis is an important factor that contributed to this retrogression, but the more fundamental cause is that the reform in 2005 has failed to achieve the expected results.

According to Yu Yongding[8], the so-called "managed floating exchange rate regime" is actually the "BBC" regime, namely, the Band, Basket and Crawling. The actual floating band has not changed much under the new exchange rate regime, which is sill focused on "management" rather than "floating"; the currency basket has not been formally developed; what we can see is only an appreciation of around 6% per year. It is undeniable that the introduction of this regime has played a positive role in stimulating domestic demand, reducing trade surplus and improving

[8] Yu Yongding: "The Reform of the RMB Exchange Rate Regime: A Historic Decision", Financial Times, 23 July, 2005

the competitiveness of enterprises. However, these effects are very limited and can not have a fundamental impact on the imbalance in the balance of payment, the excess liquidity or the inflationary pressure. The RMB appreciation expectation has led to more international hot money flooding into the domestic market. As the pace of "crawling" is determined by "management" and the managers can not take the role of the market in terms of price discovery, thus no one is clear about the target of the "crawling". At this stage, returning to the original regime pegged to the U.S. dollar is equivalent to declaring the failure of the 2005 reform while it's pretty hard to continue "crawling". Trade frictions will intensify in the process of recovery, thus the RMB exchange rate regime will be subject to pressures from international trade and international relations as well as from domestic economic development.

The key to the reform of the RMB exchange rate regime is to open the capital accounts; and the long-term goal is for RMB to become an international trade settlement currency and an international reserve currency. Now the remaining items that haven't been opened amongst some forty capital accounts are: external debt, foreign direct investment and capital market. I think that, in the reform process, the first two items should be opened up first and the third item should be opened up gradually through QFII scheme, to allow a gradual move towards a market-based exchange rate regime and ultimately fulfill the full liberalization of capital accounts. Meanwhile, we should accelerate the RMB cross-border trade settlement; promote the establishment of the offshore RMB trade center in Hong Kong and the corresponding offshore RMB fixed income securities (bonds) center. We should develop the corresponding timetable and roadmap in accordance with the goal and ideas above and complete this significant reform in the next 5-10 years.

iv. Raw materials

We should gradually raise the resources tax rate to truly reflect the prices of scarce resources in order to reduce the misuse and waste of resources and to encourage enterprises to improve their labor productivity.

Public Utilities mainly include: water, electricity, gas, transportation and etc. They have both commercial nature and public nature. Long-term price controls will distort the allocation of resources, resulting in waste and increase in government subsidies. We should promote the price reform in line with the objective of market-orientation or quasi-market-orientation according to the characteristics of these products (services).

3. Reforming the state-owned enterprises system and promoting the privatization of state capital

The state-owned enterprises (SOEs) are the legacy of the planned economy and they discharged important duties in the early stages of China's industrialization. Thirty years ago, China started its transition from a planned economy to a market economy. The transition indicated the introspection and criticism about Stalin and Mao Zedong's socialist planned economy from ideological and theoretical perspective and also a deeper understanding of the modern market economy. We have had an ideological remoulding and new theoretical explanation of the basic characteristics of socialism, such as: pro rata distribution to each according to his work as planned. However, the basis of public ownership, the most important characteristic of socialism, has almost remained intact except for a few amendments. The view that the SOEs are the major form of public ownership has cast ideological light on the reform process. In recent years, the SOEs reform has gone back to "the SOEs advance as the private sector retreats" (state-owned enterprises to control industries relating to national strategic security and people's livelihood) from "the SOEs retreat as the private sector advances" (state-owned enterprises to withdraw from competitive industries). The government has played a key role in fighting the financial crisis, initiating trillions of dollars of investment, which relied mainly on state-controlled commercial banks and large SOEs, while the private capital has been crowded out of the market. This phenomenon has raised concerns. The positioning and the future solution of the SOEs is not only related to the direction of the market-oriented reform, but also related to the people's interests.

First, we should distinguish between SOEs and public ownership from a theoretical perspective. Public ownership is mainly an ownership system at the national economy level, while the so-called public-owned enterprises refer to the enterprises in which all the employees equally have stakes at the enterprise level. In the process of economic transition, China has changed from the pure public ownership (including the whole people ownership and the collective ownership) into a mixed-ownership; thus public ownership is no longer the property of China's state ownership system. The joint-stock enterprises, including the employee stock ownership, can not be referred to as public-owned enterprises. In the market economy, SOEs are those funded by government's finance. There're mainly two types of SOEs in market economy: one is businesses of little commercial value, such as roads, ports, airports and other infrastructure in early stages; the other is various types of "sovereign wealth funds", whose purpose is to obtain appreciation in fiscal surplus or balance of payment surplus. Most of natural monopolistic industries are operated by the private sector through competitive bidding, licensing and regulation.

Second, it's actually Lenin's idea of "control the commanding heights" to have the SOEs take the mandate to protect national strategic security and people's livelihood. National strategic security and people's livelihood are the issues each country in the world has to deal with. It's only through improvement in laws, institutions and competitiveness rather than direct control on ownership that can the two issues get resolved. On the one hand, such concept and policies obscure the commercial nature of SOEs and endow them with some public responsibility; on the other hand, they justify the rationality of SOEs in monopolistic industries.

Over the past three decades, the SOEs reform has achieved great success by delegating powers and sharing benefits, transforming operational mechanism, resolving redundancy, improving incentives, establishing modern enterprise system and listing in the capital markets, however the reform has not only failed to forward, but suffered a setback as well. The key issue at micro-level is how to improve the SOEs while at macro and policy level is whether or not to further carry out the unfinished reform. I think that the direction of the reform is privatization of state capital, that is, to transfer the state-owned wealth to the general public through the allocation of social security fund, sales or transfer of stock holdings in capital markets and other forms. Apparently, this process should be implemented gradually and assured to be orderly, fair and effective.

4. Promoting the political reform and achieving the transition to a modern society

The solutions of many problems in China's economic development require corresponding political reform. The core of the political reform is the recognition of the value system of modern society and democracy, on the basis of which to seek the mode of polity of its own in line with China's reality and to promote the transition to a modern society. This polity should fully embody the respect for and protection of individual rights, should show more tolerance for various concepts and ideas within the framework of the Constitution, and should provide institutional guarantee for the people's supervision and control of the public rights, thereby realizing the ideals of a "people-oriented" and "harmonious society".

The slides that accompanied these remarks follow below.

For additional information, audio, video, slide presentations and other speakers in this program, please visit: http://www.ncuscr.org/programs/chinas-economy-2010-forum-nyse

Observation and Perception of China's Economy in the Post-crisis Period

— Policy Options and Recovery Management

Dr. Qin Xiao
Chairman,
China Merchants Group
and China Merchants Bank

Agenda

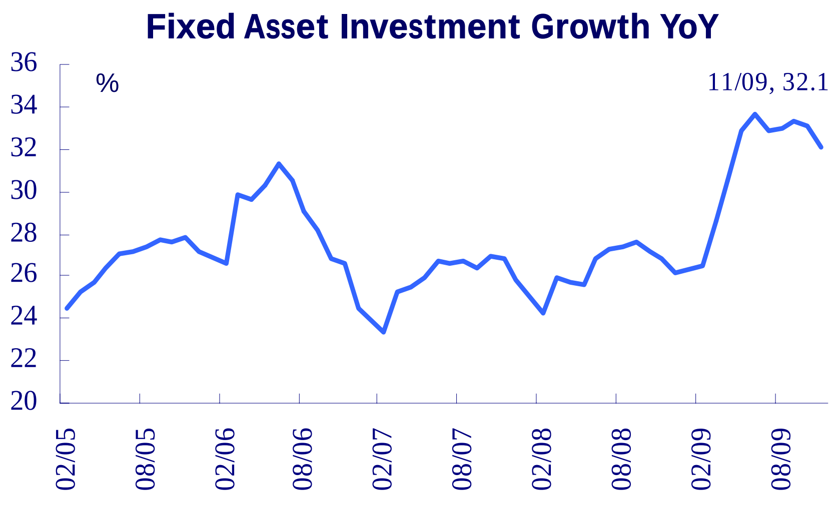
- China's Economy Entered Post-crisis Period
- Three Policy Focus:
  - Enhancing Recovery
  - Managing Liquidity
  - Rebalancing the Global Economy
- Re-launching the "Reform Agenda"

China's Economy Entered Post-crisis Period

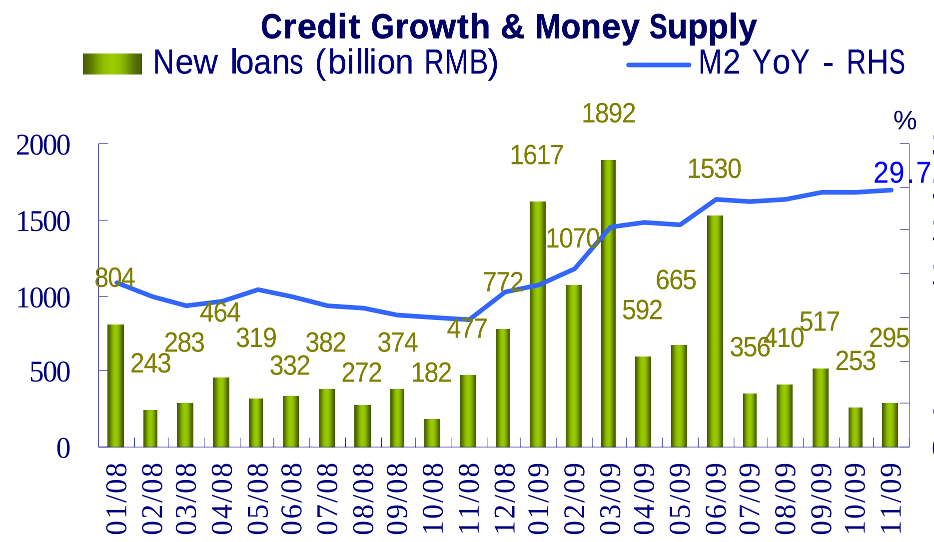
China's Economy: a typical V-shaped recovery in 2009

- China has experienced a V-shaped recovery from 4Q2008 to 4Q2009, which has been mostly driven by **government-led fixed asset investments**, backed up by **enormous credit growth**

Data Source: NBS, Bloomberg



Data Source: NBS, Bloomberg



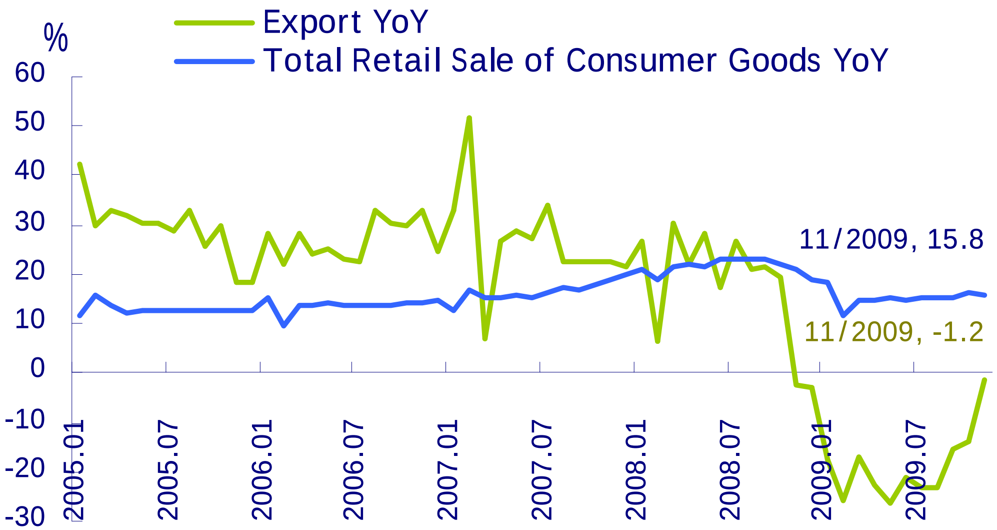
Data Source: NBS, PBoC, Bloomberg

China's Economy Entered Post-crisis Period

However, the V-shaped recovery comes at a cost

- China's recovery has been strong, however, **its economic fundamentals** including private consumption, capital expenditure by private sectors, export, corporate profitability and job creation **are still weak**
- While China's stimulus plan should be fully acknowledged, we should also recognize that **the recovery comes at a cost,** due to a possible **policy overshooting**

External demands: Negative export growth



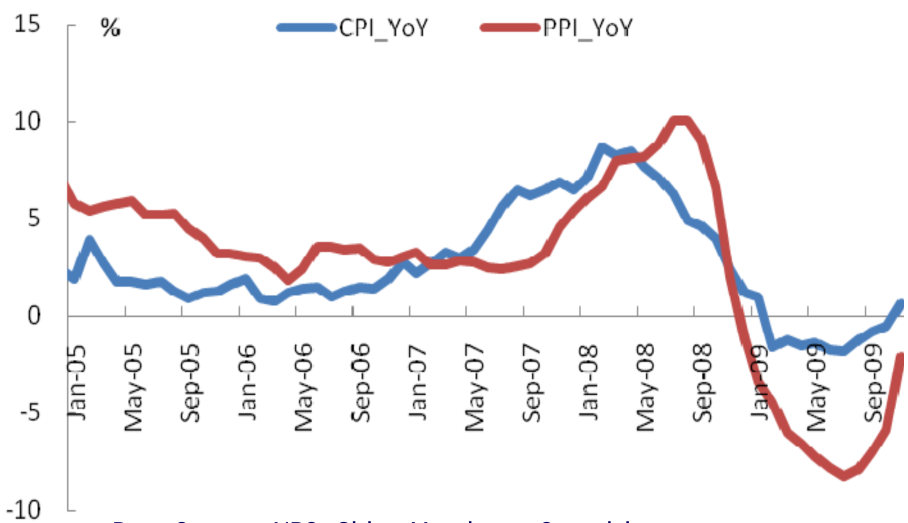
Data Source: NBS, China Customs, Bloomberg

China's Economy Entered Post-crisis Period

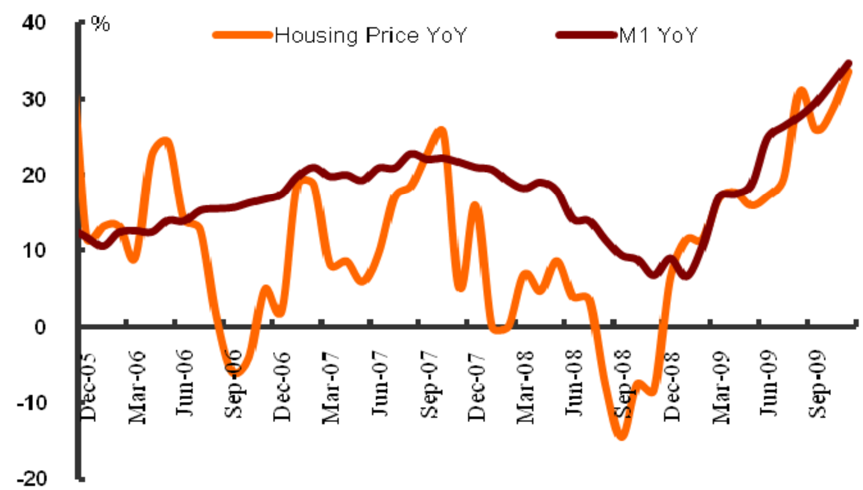
Short and Mid-Long Term Challenges

Short Term	China faces the coexistence of **deflation threat** due to insufficient end demand and excess capacity, and the **inflation expectation and asset price bubble** driven by excess liquidity
Mid-Long Term	The **imbalance of China's economic growth** has not been adjusted but **deteriorated**.

China's CPI and PPI



China's Asset Price: Housing Price



Data Source: NBS, China Merchants Securities

Policy Focus: Enhancing Recovery

The first focus of the macro policy in the "post-crisis" period is to enhance the fundamentals of the recovery

In order to correctly understand the economic recovery, special attention should be paid to the following set of indicators:

1. Year on Year Growth vs. Quarter on Quarter Growth

2. Non-governmental sector capital expenditure and household consumption

3. Corporate capacity utilization, inventory changes, CAPEX and profitability

4. CPI, PPI and asset price

5. Export and tradable industry recovery

6. Job growth and urbanization

Policy Focus: Enhancing Recovery

China's statistical system should be improved to avoid misinterpretation of the economy, and to better support policy making

GDP by Expenditure Method	Alternative Indicators of output method	Alternative Indicators Differ from Expenditure Method
Domestic Consumption (including Household and Government)	Total Retail Sales of Consumer Goods	Household services consumption (education, health care, self-owned housing, culture and entertainment and etc.) not included
Gross Capital Formation (including Gross Fixed Asset Formation and Inventory Changes)	Total Fixed Asset Investment	Purchase of land and, old buildings and old equipment included; Inventory changes not included;
Net Export of Goods and Services	Trade Balance	Trade in services not included

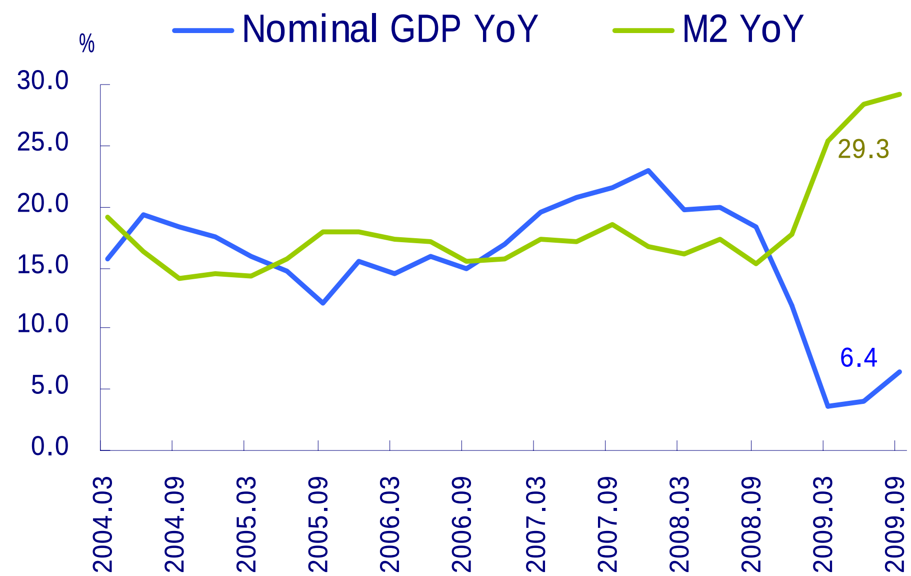
China's growth depends too much on investment and export, however, current statistical system **underestimates consumption** while **overestimate investment**

Policy Focus: Managing Liquidity

The second policy focus should be liquidity control and government's exit strategy. Timing and Instruments matters.

- Excess liquidity is less likely to be curbed in the next two years.
- Asset prices have soared, which has decoupled with the real economy.
- Hot money flood in.
- RMB is again under appreciation pressure.

The Gap of Nominal GDP and Money Supply



Data Source: NBS, PBoC, Bloomberg

The Chinese market is very sensitive to policy changes. But **policies should proactively manage the market expectations**, rather than simply wait until it's too late. Prior to raising **Interest rate, other instruments** could be used

Policy Focus: Managing Liquidity

A Possible Roadmap of Exit Strategy

1. 3Q09, **Open market operations** in order to hedge liquidity growth
2. 4Q09, Window guidance and **credit quota management** to curb loan growth
3. 1Q10, the exit of government investment-oriented **fiscal stimulus program**
4. 2Q10, hike of **bank's required reserves ratio** to absorb excess liquidity
5. 3Q10, **increase of interest rates**, mark the exit of loose monetary policy
6. 4Q10, RMB **appreciation process**, the final step of exit strategy

Policy Focus: Rebalancing the Global Economy

The third focus is rebalancing for a new global equilibrium.

- This crisis is a structural shock rather than a normal business cycle. To a large extent, the current financial crisis is deeply rooted in the **imbalance** created by the American model of **excessive consumption** and the Chinese model of **heavy dependence on exports**.
- Such a structural imbalance is a consequence of the **excessive release of economic vitality** created by **the globalization** following the end of the Cold War. From this perspective, rebalancing is a “contraction” compared with the pre-crisis level. Therefore, rebalancing is **an adjustment toward a new equilibrium**, rather than a de-globalization process.
- China and the US share a common interest to rebalance the economy. However, the road will be difficult and long, because a rude **rebalancing** might jeopardize the stability of the economy, and the stability of the society.

Policy Focus: Rebalancing the Global Economy

China's rebalancing from the supply side perspective

Supply .... Demand

- **Overcapacity**

1. Wide-range overcapacity, which is deteriorated by China's industrial revitalization plan
2. To de-overcapacity, China must properly control new investment projects, and provide bankruptcy related policies and procedures

- **Optimization of Industrial Structure**

1. Encourage the development of service industry to create more jobs and improve income growth
2. Promote industrial upgrading for higher labor productivity and international competitiveness
3. Strengthen energy saving and emission reduction efforts to make economic growth sustainable

Policy Focus: Rebalancing the Global Economy

China's rebalancing from the demand side perspective

Supply .... **Demand**

- **Slow Income Growth of Rural Population**
  1. Change the current "urban-rural dual residence system"
  2. Allow farmers to share the proceeds from rural land transfer and development
- **Improve Income Distribution**
  1. Emphasize job creation in industrial structure adjustment
  2. Orderly, effectively and fairly distribute SOE wealth to the average people to increase household asset income, enlarge the social safety net, encourage private consumption, and provide more public goods and services

Re-launching the "Reform Agenda"

Awakening "China's Reform Dormancy"

- Since 2000, China lived through the **Asian financial crisis**, accessed the **WTO**, and has been on the track of fast economic growth. However, **the pace of reform** has been **slowing down** and the country has entered a "reform dormancy" period
- **Awakening "reform dormancy" requires not only motivation but a widely accepted "Reform Agenda".** This agenda should include: the diagnosis of the problems and the solution to the problems

1. Transform the function of government
2. De-regulate price control of production factors and public utilities and promote the market competition
3. Reform the SOE system and promote privatization of state-owned enterprises
4. Accelerate the political reform: transformation to modern society

Re-launching the "Reform Agenda"

Firstly, transform the economic function of government

Problems with "Developmentalist government"

- Rent seeking, corruption
- Loss of efficiency and profitability due to bureaucracy
- Rule of fair competition undermined by government's direct resource control and market participation
- Weakened ability of providing public goods

China's high growth story ≠ Superiority of the "Developmentalism"

Changes are to be made in the government's function for a sustainable economic development:

- From a **government-led** economy to a **market-oriented** one.
- From a government focusing on **economic development** to a government dedicating to **providing public goods**.

Re-launching the "Reform Agenda"

Second, de-regulate price control of production factors and public utilities

I. Land

- **Disclose** land stock, land supply and planned acquisition
- **Share profit** from land transfer with farmers through transfer payment
- Use taxes and fees collected to **construct low-rent and affordable housing**

II. Energy

- China's imported oil has exceeded 50% of total consumption
- The final objective is to **deregulate price control** and make it **consistent with international market price**

III. Capital

- Make RMB an international **trade settlement currency**
- **Open Capital Account**: design a timetable and roadmap

IV. Natural Resources & Public Utilities

- Gradually raise the resources tax rate to truly reflect the prices of scarce resources in order to reduce the misuse and waste
- Promote market mechanism for pricing public utilities including water, electricity, gas, transportation

Re-launching the "Reform Agenda"

Third, reform the SOEs system and promote the privatization of SOEs

Reform of the SOEs:

How to improve the profitability of SOEs at micro-level

Reform of the SOEs system:
Whether or not to carry out the privatization reform at macro and policy level

Direction of the Reform: Privatization of State-Owned Enterprises

1. Transfer the state-owned wealth to the general public through the allocation to the social security fund
2. Sales or transfer of stock holdings in listed SOEs through the capital markets in a orderly, fair, justice and effective manner

Re-launching the "Reform Agenda"

Last but not least, accelerate the political reform

The core of the political reform is the **recognition of the value system of modern society and democracy**, based on which China shall seek for a political pattern suited to its own conditions

The political reform should include:

- Embodying the respect for and protection of individual rights
- Showing more tolerance for various opinions within the framework of the Constitution
- Providing institutional support for supervision of public rights

<u>To realize the ideals of a **"people-oriented"** and **"harmonious" society**</u>

Thank you!